THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?

Tuesday, February 15, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 3:00 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] Presiding.

Present: Representatives Baker, Shays, Bachus, Fossella, Biggert, Kennedy, Barrett, Brown-Waite, Feeney, Harris, Hensarling, Davis, Fitzpatrick, Oxley (ex officio), Kanjorski, Ackerman, Sherman, Hinojosa, Israel, Clay, McCarthy, Baca, Miller of North Carolina, Scott, Watt, Bean, and Wasserman Schultz.

Chairman BAKER. I would like to call the meeting of Capital Markets Subcommittee to order and welcome all of our witnesses at our rather cramped quarters today. The subcommittee meets today for the purpose of reviewing the market structure proposal under consideration currently by the SEC.

The proposed regulation NMS is aimed at the subject of modernization of United States securities markets. Supplemented in May of this year or, excuse me, of 2004 with the filing extending the comment period till June, the regulation has provoked a great deal of discussion and controversy.

Comments on the proposed rule were due January 26 of this year. It centers around three principal aspects of the current securities market. The 212-year-old New York Stock Exchange, which is clearly the leading stock option market not only in the United States but in the world, lists over 2,800 countries. New York Stock Exchange members representing individual and institutional investors bring their orders to buy and sell New York list stocks to specialists on the floor, electronically, or through a floor broker.

On a similar but slightly different path, the NASDAQ is the largest U.S. electronic market, listing over 3,300 companies and unlike the New York exchange, NASDAQ is a dealer market where buyers and seller purchase a share from the dealer or market maker through telecommunications capabilities.

The most recent development in market centers is the growth of the electronic communications network. Until the 1990s, NASDAQ was the dominant trading in NASDAQ listed securities. ECNs have initiated a different methodology of operation from the New York exchange or from the NASDAQ. There are no third party middle-

men, specialist market makers. Buyers and sellers actually meet directly and electronically. And today, two of the leading ECNs, Instinet and Bloomberg, account for about 25 percent of the trading volume in NASDAQ listed securities.

These developments have obviously caused market observers and participants to question the current regulatory structure and whether any efficiencies might accrue by a change of rule. The rule does focus on the question of the trade-through rule, its appropriateness, market access, market data and sub-penny quotations.

Via the trade-through rule, market participants are prohibited from ignoring or trading through to the best price available and executing a trade at an inferior price, even if the investor so chooses. Some broker dealers and investment advisors contend this rule has a resulting anti-competitive effect.

There is also a discussion as to whether disclosure of top of book, Market Best Bid and Offer should be the required disclosure or whether depth of book which would allow participants to voluntarily display several levels of bids and offers away from the Best Bid and Offer.

I can go on with what really is ultimately a complex subject and the decisions of which will have broad and long standing effect on market function in this country. I do wish to make a comment at the outset, however, that without regard to one's view of the trade-through's applicability in the New York exchange, I am hoping today to get a good understanding of the proposal's intent to apply the trade-through to the NASDAQ and the logic of making that the order of the day.

I do believe that our hearing will be productive. We have diverse opinions represented, and more importantly, we have very educated and insightful individuals as market participants who have been willing to come here today.

And let me extend a brief word of apology to all. I was ready this morning. Delta said they were ready; you know, they are ready when you are. I got there at 5:50 this morning, and they were not ready. So for that reason, I had to make the untimely announcement of the delay. And I know that caused each of you some personal inconvenience, for which I regret.

But to put a fine point on it, I really wanted to be here for this hearing and felt it appropriate to make that request. So thank you for your courtesies extended.

With that, I would recognize Mr. Kanjorski for his opening statement.

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, as the old joke goes, that is one. So you have two more shots, and then we shoot you. Mr. Chairman——

Chairman BAKER. I will save you the trouble. Just do it now.

Mr. KANJORSKI. Mr. Chairman, today, we meet for the fifth time in the last 16 months to evaluate the need for further reforms in the organization of our capital markets. The ongoing deliberations over the National Market System have engendered strong emotions and considerable debate.

As I have regularly observed in our previous hearings, a variety of agents in our equities markets have questioned one or more aspect of the regulatory system during the last several years. Techno-

logical advances and competitive developments have also led us to a crossroads in the securities industry, forcing us to confront a number of decisions that could fundamentally alter its organization for many years to come.

One year ago, the Securities and Exchange Commission put forth four interrelated proposals to reshape the structure and operations of our equities markets. After reviewing the comments that it received regarding these matters, the commission made a number of striking changes in its original plan and republished them for comment this past December.

Mr. Chairman, as you already know, I have made investor protection one of my highest priorities for work on this committee. It is therefore my very strong expectation that the commission first and foremost will ensure that it protects the interests of average American investors in any decision it finally reaches regarding the future of the National Market System.

Given my interest in protecting retail investors, I was very pleased that the commission decided to retain the trade-through rule when issuing its latest regulatory proposal. As one of the foundations of our National Market System this regulation has insured that all investors get the best price that our securities markets have to offer regardless of the location of the transaction.

The approval of an opt-out provision for the trade-through rule will have likely splintered our securities markets, decreased liquidity, limited price discovery and damaged our economy. Today, I also suspect that many of our witnesses will focus on the commission's newest proposal to alter the trade-through rule.

In addition to applying the trade-through rule to all securities marketplaces, the commission's latest plan for updating the National Market System includes two alternatives for implementation, the Market Best Bid or Offer Alternative and the Volunteer Depth Alternative.

Although some of our witnesses may disagree, the former approach, in my view, is the one that the commission should choose as it better protects investors, fosters competition between and within markets, and incentivizes markets to attract the most aggressive orders.

Also, the Voluntary Depth Alternative seems inconsistent with the goals of the National Market System in that it would undercut efforts to promote robust competition between markets. Moreover, the Voluntary Depth Alternative will almost certainly result in only one way for the markets to differentiate themselves, namely, how much they are willing to pay other market participants for their order flow.

In my view, promoting competition based on payment for order flow will improve—will prove detrimental in the long-term to average retail investors because the conflicts of interest it creates. This issue is one that the commission should carefully study and one that I hope our panelists will address in their comments and answers today.

Ultimately, the commission can best ensure that investors obtain the best price by balancing competition between markets with protection of the best prices in each marketplace. From my perspective, the incremental approach contained in the Market Best Bid

or Offer Alternative is preferable. The adoption of this alternative will also help to ensure that the United States maintains its global leadership in our financial markets.

In closing, Mr. Chairman, it is appropriate for our panel to conduct continued oversight on these complex issues. The observation of today's witnesses about these matters will further help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets for many years to come.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 56 in the appendix.]

Chairman BAKER. I thank the gentleman.

Mr. Shays, do you have a statement?

Mr. SHAYS. Just for the purposes of introduction, I want to extend a warm welcome to Bob Greifeld of the NASDAQ market whose nerve center is located in the Fourth Congressional District. As I do this, I am thinking probably some of you also live in the Fourth Congressional District.

Bob has done a tremendous job improving NASDAQ strategy direction since he joined the company in 2003, and I am told his graduate thesis at Stern School, where I also went, was on operation of the NASDAQ marketplace. So it seems to me he was the perfect match for the company and probably why he actually did his thesis.

Bob is an active speaker on market structure and regulatory issues, and I am pleased he could join our other distinguished guests here today to provide his thoughts on the SEC proposal.

Could I ask, is there anyone else in the Fourth Congressional District?

Bob lives in New Jersey.

Welcome. Thank you.

I tell people, being on the Finance Committee from the Fourth Congressional District of Connecticut is like being—living in Iowa and being on the Agriculture Committee.

Chairman BAKER. Thank you Mr. Shays.

Mr. Ackerman.

Mr. ACKERMAN. I just want to thank the Chairman and the Ranking Member for calling this hearing, and I am anxious to hear from the witnesses.

Chairman BAKER. I thank the gentleman.

Mr. Bachus.

Mr. BACHUS. I thank the chairman.

I am not going to ask how many of you are from Alabama. First of all, I thank Chairman Baker for his leadership on the issue. As you know, a significant part of the proposed reg NMS purports to reform the so-called trade-through rule and extend its application marketwide or intermarket. While the repeal of the trade-through rule makes more sense, the SEC appears to be past that point.

According to the SEC's own studies, the trade-through problems in the New York Stock Exchange and NASDAQ markets are roughly the same and not very large. About 2.5 percent of the trades are traded through in both markets.

So why extend the rule into the market that does not have one, the NASDAQ?

A trade-through rule is unnecessary for the NASDAQ market and, if anything, would reduce execution quality by slowing down the execution times. A more appropriate approach, I would suggest would be to reform the trade-through rule and the listed market, the NYSE, where there is already such a rule but where clearly the rule is flawed.

Once the SEC is confident that they have reformed, that they have a reform rule or they have the reform rule right, then consideration could be given to extending the rule's application to the NASDAQ market.

Just a short suggestion, short statement.

Thank you Chairman Baker.

Look forward to hearing from our witnesses.

Chairman BAKER. I thank the gentleman.

Mr. Israel.

Mr. ISRAEL. Thank you Mr. Chairman. Thank you for convening this hearing.

In the interest of the committee's time, I will insert my statement for the record. I want to give them more time to speak than me.

Chairman BAKER. I thank the gentleman for his leadership.

Mr. Fossella.

Mr. Hensarling, did you have a statement?

Mr. HENSARLING. Thank you Mr. Chairman.

First, hailing from the Dallas Fort Worth metroplex, home of American Airlines, I might point out, Mr. Chairman, they got me here on time this morning. And as we explore increased competition within the securities market, we may want to explore it in the airline arena as well.

I appreciate the chairman for holding this hearing. As a believer in the free market system, I believe that Congress must constantly search for ways to foster more competition within our financial markets and allow them to become more efficient.

Along these lines, I have paid particularly close attention to the SEC's reg NMS proposal. It is my opinion that the nearly 30-year-old trade-through rule is too limited in scope to take into account the many factors that investors consider when executing trades in today's modern high-speed markets. And I have great concerns about any expansion of this arguably antiquated rule. And I certainly do not need to be convinced that more government mandates typically lead to less private sector innovation.

I hope that this debate will continue to focus on what enhances competition and thus what is best for the American consumer, because only each individual investor knows what his short-term and long-term goals are. And certainly, institutional investors have different priorities. I question whether this rule truly protects investors in today's, much less tomorrow's, high-speed markets.

I am additionally unconvinced that reg NMS should favor one particular market or market structure. Instead, shouldn't we be trying to foster and encourage competition between markets?

So as the SEC continues to determine how best to revise the regulation, it is my hope that they will keep in mind the importance of free and open competition in the American economy and the role that we have as a world leader in financial services.

Thank you Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentleman.

Mrs. McCarthy.

Mrs. MCCARTHY. Thank you, Mr. Chairman, I also will submit my questions, and I am actually looking forward to hearing from the committee.

Chairman BAKER. I thank the gentlelady.

Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you Mr. Chairman.

And to the distinguished panel of experts who are prepared to give testimony today, I appreciate your taking the time to be here. Even though I am new to this committee and to these rather complicated market structure issues, it seems that market forces and technological advances have made trading stocks today much more efficient and transparent than ever before.

With decimalization and the rise of electronic trading, investors today are receiving better prices and faster trades than they were say just 5 years ago. Despite the wide-ranging viewpoints of our exceptional panel of witnesses, we can all agree that the work must still be done to fully modernize the structure of our equity markets. I commend the Securities and Exchange Commission for its timely proposal, regulation NMS, which aims to complete this modernization.

However, one part of the proposal, extending the trade-through rule, does not appear to much offer efforts to modernize our equity markets. I am apprehensive about government regulations that can strain competition. Competition in the marketplace generates innovation, which leads to greater productivity. Automatic market structures and mechanisms have lower trading costs, bypassing obsolete market mechanisms that cost public investors unnecessary trading costs.

It seems this rule may be an unnecessary second layer of regulation.

Aren't investors protected by their brokers best execution obligations?

Nonetheless, we must be certain that we are protecting the investor, in particular small investors. These investors happen to be my constituents, the residents of Pennsylvania's Eighth Congressional District who have pensions, 401(k) plans, mutual funds and investments in stocks and bonds. I need to know in what way the SEC's proposal affects the everyday lives of my constituents. But before I make that final judgment, I would like to hear from our distinguished panelists. I yield back my time.

Chairman BAKER. I thank the gentleman.

Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I certainly want to thank you, Mr. Baker and Ranking Member Kanjorski, for holding this hearing today regarding the Securities and Exchange Commission's proposal to modernize the National Market System. I understand that the proliferation of electronic computer networks have changed the way that investors trade in the markets, which is the reason the Securities Exchange Commission needs to update the current National Market System.

It is clear from the written testimony of the witnesses that there are a wide range of opinions on the best approach for assuring intermarket price protection. Indeed, some of our witnesses today believe that, in light of current best execution obligations and other existing practices, no such assured protection is necessary.

However, one question that I would like to focus on today is, if the ultimate policy decision is to try to strengthen and expand existing trade-through protection, would it make sense to do so in an incremental fashion?

And also I would like to weigh the potential costs to participants in relation to the benefits that new rules would provide to markets. And then, of course, there is the fundamental question, is there a need for a trade-through rule, or does a broker's responsibility to obtain best execution of customer orders provide the sufficient protection for customers?

As this subcommittee reviews these proposed regulations, we must keep in mind the need to have an efficient national system that provides the best prices for a wide variety of investors. With that in mind, Mr. Chairman, I look forward to hearing from the distinguished panel of witnesses, and I yield back the balance of my time.

Chairman BAKER. Thank the gentleman.

Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman and Ranking Member Kanjorski.

I do want to mention, Delta was ready when I was this morning at 5:55, so we are here.

It is a great opportunity to have this dialogue today. The dramatic improvement of communication technology, just literally a generational leap in the last 5 years, demands that we evaluate the applicability of all regulations, policies and procedures from the Federal Government that could assist or impair the function of our markets and ultimately the functioning of our economy.

I am looking forward to this dialogue to address regulations, the process and procedures to ultimately assure that we can protect investors, especially working Americans who are building a nest egg for the future and whose future economic growth rests largely on our work in this room on both sides of the table.

I am excited about this discussion. And I hope the outcome will be ensuring free and fair markets that encourage investments and create jobs.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. Wasserman Schultz.

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman.

It is a pleasure to be here with you today and with Ranking Member Kanjorski and members of the panel. Appreciate you taking this time to articulate your concerns with regard to the SEC's revised National Market System proposal. I am looking forward to hearing from the panelists, and I am sure that the differences among them with regard to the efficacy of trade-through reform will only reinforce the contentious nature of this issue and the absence of a clear regulatory solution. As this process moves forward, I encourage the commission to be as fair as possible and to proceed

with restraint when considering reforms that will affect our nation's financial markets.

I personally have reservations about imposing regulations that may damage our internationally competitive investor-driven markets. I believe we must always be wary of the unintended consequences that reforms may impose upon the very markets that sustain our national economy. Thank you, and I yield back the balance of my time.

Chairman BAKER. Thank the gentlelady.

Mr. Fossella, did you have a statement, sir?

Mr. Barrett?

Mrs. Biggert?

Mr. Feeney?

Mr. Watt?

Mr. WATT. I pass.

Chairman BAKER. Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. I will pass.

Chairman BAKER. We are on a role. Mr. Clay.

Mr. CLAY. None.

Chairman BAKER. Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman Baker and Ranking Member Kanjorski, I want to express my sincere appreciation for you holding this very important and very timely hearing. Unfortunately, I will not be able to stay for the entire hearing due to a scheduling conflict with another committee, but I look forward to reading the testimony of today's witnesses and the transcript of today's hearing.

This subcommittee has held a number of hearings on the Securities and Exchange Commission's proposed National Market System regulation, and we have heard from a number of witnesses on the proposal. Today, we will hear from some witnesses, including exchanges, ECNs and others, on yet another aspect of the Securities and Exchange Commission's National Market System proposal originally designed to update and strengthen our national securities markets.

As most everyone in this room and those listening or watching knows, the Securities and Exchange Commission proposed regulation NMS last year in the attempt to modernize U.S. market structure. In May 2004, the SEC decided to extend the comment period to June 30, 2004, in part likely due to the amazing amount of interest in the importance of and the controversy surrounding this proposed regulation.

Once all the comments were in, the SEC decided to propose two alternatives to the original NMS proposal. The commission republished the two alternatives to the proposed regulation for comment. And now that all those comments are in, the SEC is reviewing all of them and will issue its final regulation reportedly at the end of this quarter.

While working on proposed changes to the Real Estate Settlement Procedures Act last year, I was amazed and surprised by the number of steps that can be taken by certain groups to interfere with the regulatory process in an attempt to either slow down the process or to use certain ways and means to arrive at the end they desire.

The fundamentally flawed proposed changes to the Real Estate Settlement Procedures Act were ultimately and thankfully withdrawn as the result of efforts by myself, Mrs. Biggert, Senator Wayne Allard and our letter in opposition cosigned by well over 250 Members of Congress. All this to say that it is amazing what a few of us here in Congress can defeat when we put our hearts into it.

I realize that the SEC is now considering two alternatives to the NMS regulation. And Mr. Chairman, I have serious reservations about the Voluntary Depth Alternative. It could radically change the structure of the U.S. capital markets and damage our internationally competitive investor-driven markets.

I urge the SEC to reject the Voluntary Depth Alternative. In this instance, I hope that the SEC will complete the task that we set out to do last year and will issue a final regulation soon.

Mr. Chairman, Ranking Member Kanjorski, again, I wish to express my sincere appreciation for you holding this important hearing today. I yield back the remainder of my time.

Chairman BAKER. I thank the gentleman.

Ms. Bean, did you have a statement?

Is there any member wishing to make a further statement?

If not, at this time, I would like to proceed to call on our panel, and I am, again, appreciative for so many of our distinguished participants willing to give us their time this afternoon.

Our first is Mr. Edward J. Nicoll, chief executive officer, Instinet group incorporated. As is the usual custom, we ask that you try to limit your statement to 5 minutes. Your full statement will be made part of the official record. And otherwise, proceed as you like.

STATEMENT OF EDWARD J. NICOLL, CHIEF EXECUTIVE OFFICER, INSTINET GROUP INCORPORATED

Mr. NICOLL. Mr. Chairman, I am wondering whether I should draw any inferences from the fact that I am seated at this—apparently at the children's table here today.

But thank you Chairman Baker, Ranking Member Kanjorski and members of the subcommittee. Thank you for inviting me to appear today to discuss the SEC's latest version of reg NMS.

This subcommittee has held hearings throughout the formation of the rule, and I greatly appreciate the time and effort you have taken to understand the complexity of this issue.

Chairman BAKER. Mr. Nicoll, if you could pull that mike a little closer. They are not real sensitive. You almost have to——

Mr. NICOLL. How about that?

Chairman BAKER. That is much better. Thank you.

Mr. NICOLL. As I said, I greatly appreciate the time and the effort that the committee has taken to understand the complexity of this issue. In particular, I want to thank Chairman Baker for your leadership.

This afternoon, I would like to spend a few minutes on the trade-through rule. When the SEC re-proposed regulation NMS last December, Commissioner Cynthia Glassman encouraged those submitting comments not just to consider what type of trade-through they preferred, but if any trade-through rule was even necessary.

We have taken Commissioner Glassman's words to heart and continue to advocate for the elimination of the trade-through rule. Its repeal would foster competition without favoring one market model over another.

I must say that I was surprised by the re-proposed rule, since, even at this late date, the case for the trade-through rule has not been made. Sound economic principle, solid data and real-world experience must be our guides when implementing rules that will impact our nation's capital markets.

Let's look at the facts surrounding the trade-through rule. First, it is said that the rule is necessary to protect investors from unscrupulous brokers that may execute customer orders at inferior prices. But once it became apparent that the inclusion of an opt-out provision could have addressed such concerns, advocates of regulation had to shift their rationale for preserving the rule.

The new defense of the trade-through rule is that it encourages limit orders. The example given by supporters is of the retail investor who posts a limit order only to watch in dismay as other markets ignore his order. All of this causes the investor to lose confidence in the market and stop posting limit orders. With fewer limit orders, spreads widen and market quality is compromised.

It is a good story, but with a significant flaw. There is no evidence to support it. Moreover, the absence of a trade-through rule in other markets shows no evidence of such a loss in confidence. In fact, retail investors have shown a preference for placing limit orders in NASDAQ where there is no trade-through rule.

I am concerned that the SEC has adopted the position that the trade-through rule promotes limit orders based on research that seems to prove just the opposite. In its own study, the SEC examined 4 days of trading in 2003. And what did it find? The trade-through rate for NASDAQ listed securities was just 2.5 percent of the trades. This finding can only mean that supporters of the trade-through rule believe that even though more than 97.5 percent of the time a limit order is not traded through, the mere 2.5 percent risk of being traded through is enough to discourage limit orders.

This just does not seem to be the case. In fact, some of the largest brokerage firms that represent individual investors, including Schwab, Ameritrade, Morgan Stanley, Scottrade, and even Goldman Sachs, report that they receive more limit orders for NASDAQ stocks where there is no trade-through rule than for New York Stock Exchange stocks where there is.

Further, the SEC's own study also noted that there were more limit orders placed in NASDAQ stocks than New York Stock Exchange stocks. So based on these numbers, shouldn't the SEC be eliminating the rule entirely, as commissioner Glassman suggests?

Unfortunately, the SEC instead has indicated that it will impose the regulation on both the NASDAQ and the New York Stock Exchange and has only asked for a public comment on its two ways to apply this expanded trade-through rule, top of book and voluntary depth of book. This is a false choice. Neither is a step forward.

Moreover, public comment letters to the SEC make it clear that there are sharp divisions on this issue. The New York Stock Ex-

change and some others are strong defenders of the regulation. Yet 37 members of the House and Senate signed comment letters last year calling for a repeal of the trade-through rule or, at a minimum, the inclusion of an opt-out provision. They were joined by statewide officials from coast to coast, ranging from California Controller Steve Westly to Florida Attorney General Charlie Crist.

Also calling for a repeal or opt-out were more than a dozen State pension funds and labor unions, including some of the largest like CalPERS, OPERS, the Teachers' Retirement Systems of Louisiana, Indiana, and California; and TIAA-CREF. Major financial institutions, such as UBS, Morgan Stanley, JP Morgan, Merrill Lynch, and Citigroup joined retail firms like Ameritrade, Fidelity and Schwab as they all called for the rule's repeal or an opt-out exception.

Such sharp divisions should be taken very seriously. We are considering fundamental changes in how our markets operate and compete. While we should not expect full consensus across our industry, I would think the SEC would be wary of sweeping changes with their related costs to investors in the face of such a deep split and with so many questions still unanswered.

Let me conclude with Instinet Group's position on the key issues. First, the trade-through rule is an unnecessary burden that hinders competition, ultimately harming rather than protecting investors.

Second, on no account should the trade-through rule be extended to the NASDAQ marketplace. The NASDAQ market is an example of a highly liquid and highly competitive market where the competition has reduced investor costs, narrowed spreads and improved performance for all investors.

As Chairman Donaldson himself said when re-proposing reg NMS, quote, We need to identify real problems, consider the practical consequences of possible solutions, and then move pragmatically and incrementally towards the goals Congress staked out, unquote.

Applying the trade-through rule to the NASDAQ marketplace is not a pragmatic and incremental move. It should be taken only when it is clear that the market is failing and less drastic remedies are inadequate.

And third, if the SEC still feels the overwhelming need to protect limit orders by strengthening the trade-through rule and imposing it on the NASDAQ marketplace, it should implement a consistent rule that protects all limit orders to its voluntary depth of book proposal and not one that protects the lucky few at the top of the book.

I have commented in greater technical detail on our positions in the documents accompanying my remarks today and ask that they be included in the record. I thank you for your time and effort and would happily answer any questions you might have.

[The prepared statement of Edward J. Nicoll can be found on page 184 in the appendix.]

Chairman BAKER. Thank you very much, sir. Our next witness is Mr. Robert G. Britz, president and the co-chief operating officer of the New York Stock Exchange.

Welcome, sir.

STATEMENT OF ROBERT G. BRITZ, PRESIDENT AND CO-CHIEF OPERATING OFFICER, NEW YORK STOCK EXCHANGE, INC.

Mr. BRITZ. Thank you Chairman Baker, Ranking Member Kanjorski and members of the subcommittee. Appreciate the opportunity to be with you this afternoon to articulate the NYSE views on this important issue.

Mr. Chairman, while we have filed written testimony addressing a variety of the aspects of reg NMS, I thought I would address my verbal remarks to the question that is posed in the title of this hearing: Will reg NMS actually enhance the competitive position of our markets?

In my view, the answer to that question is categorically yes. In that regard, I would offer the following general observations. Reg NMS approach to the trade-through utilizing the Market Best Bid effort will incent markets to compete for investor orders by offering them speedy executions and, importantly, at the best price. It will incent someone seeking counter-party interest to improve upon the existing market, thereby reducing bid offer spreads. It will require markets to adhere to a minimum standard of speed in order to compete. It will reward those who create the most marketable bids and offers, thereby encouraging quote competition. And then, very importantly, it strikes a balance between the pure order competition of a consolidated limit order book and market competition that arises from linking competing markets. Specifically by continuing to encourage intermarket competition, reg NMS will help to boost the U.S. capital markets' competitive position globally and particularly when compared with the government monolith that would inevitably spring from a consolidated limit order book.

More specifically, I would offer as Exhibit A of the pro-competitive benefits of reg NMS the NYSE's proposal for a hybrid market. While the hybrid is driven by our evolving customer needs and by our own productivity initiatives, wanting to be aligned with the provisions of reg NMS was clearly a part of our thinking. Without getting into the specifics, through a series of hardware and software initiatives between now and this time next year, the hybrid market will enable our customers to execute in our market electronically, anonymously, in subseconds and with no size restrictions. They will see the complete limit order book in real time. They will have the opportunity to reach into that book at multiple prices or sweep to a particular price if they care to do that. They will be able to place undisclosed interest to a broker in the quote or on the book at various price points as they see fit. Their orders will be auto routed to other markets to the extent that better prices exist in other markets. Incoming orders from other markets will be automatically executed in the NYSE market, and in general, both brokers and specialists and by extension the NYSE market will be significantly more productive.

I think reg NMS is particularly pro-competitive in the way that it adeptly deals with the trade-through issue. Amid calls, albeit from a small minority, to allow markets to ignore investors' better-priced orders in other markets, the reg NMS proposes to strengthen and extend the current trade-through rule. The commission correctly recognizes that trade-throughs inherently involve treating investors unfairly, never a good idea, and especially so in an environ-

ment already tainted by questionable practices on the part of some corporate officials, some auditors, some research analysts, some mutual fund executives, and some securities dealers.

Trade-throughs are symptomatic of inefficient markets. Indeed, only an inefficient market could give rise to a trade-through. They are a violation of the trust investors place in the market and inconceivable with any notion of fair dealing. Trade-throughs devalue price as an order execution element and weaken the equity pricing mechanism. They create a disincentive for investors and traders to post better prices because there can be no assurance that doing so will be rewarded.

When competing to establish the best price is no longer the key to attracting orders, markets will regress to the lowest common denominator relative to price. When one considers that the fundamental mission of the stock market is to efficiently price securities, how can the price at which investors trade not be paramount? Remember, in a trade-through scenario, several things occur, none of which is desirable. In the first case, one investor pays more or sells for less than is possible. Another investor gets completely ignored, notwithstanding being willing to pay the best price. And importantly, the company shares are mispriced, and trading is more volatile than would otherwise be the case. And so the SEC has proposed reg NMS to create an environment where investor orders will be rapidly executed and at the best prevailing price.

This proposed trade-through rule has the practical and desirable effect of directing investor orders to markets that deliver the best prices. And in so doing, it incents competition among those markets to establish efficient prices. Through reg NMS, the SEC is wisely not dictating market structure. It is creating a framework that allows markets to choose the combination of services they wish to offer and lets investors decide which services best meet their needs. Reg NMS encourages well functioning capital markets and highlights the importance of investor confidence in ensuring that result.

Were trade-throughs to be sanctioned by the SEC and, therefore, commonplace, how long will it take investors whose orders are ignored to lose confidence in the systems' ability to meet their needs? How long before corporations experience a higher cost of capital due to the increased volatility in their shares? And how long before U.S. capital markets lose ground to foreign competition due to a decline in the efficacy of the securities pricing mechanism?

At the end of the day, Mr. Chairman, the investor willing to pay the highest price and his counterpart willing to sell for the lowest price ought to trade. Anything else is not only counter-intuitive, it is downright inefficient. Worst than that, it is anti-investor.

In closing, I would like to commend the committee for conducting this hearing and particularly for correctly framing this in terms of the competitiveness of our markets. Speaking for my own organization, the NYSE is by far the largest and most important equity market in the world. Its growth parallels the growth of the U.S. economy. It has helped to both fuel the growth of U.S. enterprise and maintain the global preeminence of the U.S. as a capital market.

At the risk of stating the obvious, there is a lot riding on the markets, the SEC and policymakers. Making sure that the question

posed in the title to this hearing, the answer to that question is a resounding yes. Thank you, Mr. Chairman.

[The prepared statement of Robert G. Britz can be found on page 114 in the appendix.]

Chairman BAKER. I thank you very much sir.

Our next witness is Ms. Carrie E. Dwyer, general counsel of the Charles Schwab Corporation.

Welcome.

STATEMENT OF CARRIE E. DWYER, GENERAL COUNSEL, THE CHARLES SCHWAB CORPORATION

Ms. DWYER. Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, my name is Carrie Dwyer. I am general counsel of the Charles Schwab Corporation. I also have the distinction, along with some colleagues at the New York Stock Exchange, of being one of the drafters of the original trade-through rule.

I am pleased to be here today to present our perspective on an issue that has direct consequences for the individual investors that we serve. For more than three decades, Charles Schwab has been providing individual investors with efficient access to the markets and the tools they need to make informed investment decisions. Today, we serve more than 7.3 million clients with nearly $1.1 trillion in client assets. On an average day, our customers trade about 3.6 million shares on the New York Stock Exchange and NASDAQ combined.

Whether investing in equities, mutual funds or through an investment advisor, our customers' investment returns depend on efficient execution. Our customers demand ever greater efficiency, better service and lower cost from us. We believe a regulatory structure that promotes vigorous competition between markets will generate the innovation that will deliver those benefits now and in years to come.

As you know, Mr. Chairman, Congress has historically rejected the idea of a government-designed central market. Instead, over the years, this committee has wisely decided to allow market structure to evolve through the interplay of competitive forces while limiting the SEC's role to market oversight.

Members have generally agreed that legislators and government regulators cannot foresee how technology and investing will resolve, nor should they choose which competitor should succeed and which should fail. This policy has served us well over the years, fostering the highly efficient and technologically advanced market that we enjoy today, which makes it difficult to justify the SEC's plan to abandon this approach.

Regulation NMS and the proposals for expanding the trade-through rule represent a fundamental redesign of the equity markets. In this proposal, the commission seeks to substitute its own algorithm for the interaction of competitive market forces, creating in effect a central market system. Brokers will be forced to route to markets that may not necessarily get the customer the best overall price and which they would otherwise seek to avoid because of a variety of factors, old-fashioned order handling procedures, cumbersome technology or capacity or reliability concerns.

Should this design be adopted, there will be no incentive for markets to compete on how orders are executed or how they discover prices or depth because exchanges are guaranteed to receive orders no matter how moribund their technology. Without an incentive to innovate, technological and operational efficiency will suffer.

As numerous experts have pointed out, with every broker forced to route to the same market to take out the same quote where they trade, there is a serious risk of market gridlock. With the advent of Internet trading, our customers are used to getting the price they see on the screen within seconds of entering the order. What will we say to them when their orders start taking longer to execute and at worse prices? What is the SEC's justification for this radical change? It is hard to find a solid empirical basis in the commission's release. Is the rationale for a trade-through rule the quality of effective and quoted spreads?

Our experience with our own order flow has shown us market quality improvements in the transfer just last fall of the QQQQs from the listed markets which have a trade-through rule to NASDAQ which does not.

Is the rationale high rates of trade-throughs? The commission found reported rates of the trade-throughs, as Ed has said, of about 2 percent. Seems too small to justify changing how the other 98 percent of orders are handled. In any case, the commission reports that the trade-through rate is about the same for the New York Stock Exchange which has a trade-through rule and NASDAQ, despite the differences in market structure.

Is the rationale to encourage greater use of limit orders? Our own customers choose to enter twice as many limit orders on NASDAQ, which has no trade-through rule, than the New York Stock Exchange.

Do not be misled by those who will argue that a trade-through rule is merely about requiring that customers get the best price. From the customer's perspective, the issue is not whether the first part, the first hundred shares of their order is executed at the best quote. The issue is whether they are getting the best price overall for their whole order. There are many factors that go into that analysis, such as speed and the ability to discover additional liquidity for an order.

Contrary to the claims of others, the SEC's top of book proposal will result in situations in which individual investors do not receive the best prices for their trades. The SEC's experimentation with the new market design stands in striking contrast to its slow response to a well documented problem that has continued to disadvantage investors. Under the current SEC rules, the exchanges operate as a cartel to fix the price of market data and restrict access to data to the detriment of all investors, but especially individual investors who cannot afford the hundreds of dollars a year the exchanges charge for access to quote services that display market depth information.

Needless to say, access to quality market data is vital to the functioning and fairness of our markets. We are talking about a depth of book proposal, but no one can see, other than institutional customers, can see depth of book today. Despite 5 years of study, comment, and debate, the commission proposal is only a first step

that merely reapportions the pool of money and fails to address the root cause of the problem and the inequities it creates.

Mr. Chairman, facilitating competition means eliminating barriers to competition, such as the trade-through rule, that guarantee a market will receive business even if it refuses to evolve. And it means facing up to cartels that place individual investors at a disadvantage. Regulation NMS represents a step that requires reconsideration by the commission with the thoughtful input of this committee.

While Congress has traditionally respected the SEC's historic role in terms of market oversight, it has consistently reaffirmed that competitive market forces should shape market structure, and it should do so again. Thank you for allowing me to share my views, and I look forward to answering any questions.

[The prepared statement of Carrie E. Dwyer can be found on page 129 in the appendix.]

Chairman BAKER. I thank the gentlelady.

Our next witness is Mr. Matt Andresen, President Citadel Execution Services.

Welcome, sir.

STATEMENT OF MATT ANDRESEN, PRESIDENT, CITADEL EXECUTION SERVICES

Mr. ANDRESEN. Thank you. Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, I am Matt Andresen, president of Citadel Execution Services, an affiliate of Citadel Investment Group. Prior to joining Citadel, I was CEO of Island, at the time the largest electronic communications network. On behalf of Citadel, I welcome this opportunity to present our views on the proposed National Market System regulations issued by the SEC.

Citadel manages approximately $11 billion in investment capital from its headquarters in Chicago and offices in New York, San Francisco, London, and Tokyo. On average, Citadel accounts for between 1 and 2 percent of the daily dollar volume traded on both the New York Stock Exchange and NASDAQ and for more than 10 percent of daily U.S. options volume. With nearly a thousand employees and as an active and substantial investor in the U.S. and throughout the world, Citadel has a vital interest in the development of fair, efficient, transparent, and liquid markets.

Because the trade-through rule implicates fundamental questions regarding the transparency and efficiency of the markets, the issues to be addressed at this hearing are of great importance to all investors. American investors, whether retail or institutional, have a vested interest in insuring that U.S. markets remain the strongest and most efficient markets in the world.

I would like to refer the committee to our written testimony, which I have submitted and briefly summarizes our position. The status quo is not acceptable. Citadel is not an exchange but rather a customer of exchanges. And as such, Citadel is well acquainted with the limitations of the current regulatory regime. Citadel believes that the existing trade-through rule is unnecessary and should be eliminated.

However, the top of book proposal, if adopted, would be substantial improvement over the current regulatory framework. Specific

benefits would include, one, the ability to bypass manual markets where appropriate; two, the ability to use an intermarket sweep exemption to execute large institutional orders cleanly and efficiently; and three, the creation of a clear incentive for manual markets to automate. Citadel has asked the commission to act quickly to either eliminate the existing trade-through or to adopt a revised rule.

In addition, given that the US options markets are plagued with the same market structure problems as the NYSE and AMEX listed equity markets, Citadel has requested the SEC extend any proposed trade-through changes to the options markets.

We would now like to respond specifically to the questions raised by the committee. First, Citadel does not believe that a compelling empirical case has been made for the extension of the trade-through rule to all NMS stocks. Specifically, Citadel does not believe there is any discernable policy justification for any application of the trade-through rule to electronic markets. In the marketplace for NASDAQ stocks, where there is not a trade-through rule and quotes are generally immediately and electronically accessible, market quality is superior and trade-throughs are not an issue.

With regard to questions on top of book versus depth of book, Citadel would support a top of book provided there is an ability to bypass manual markets, an intermarket suite exemption, and a clear definition of an automated market.

You have also asked what the consequences are if this proposal is adopted. Citadel believes the markets and, therefore, all investors would be better served by an abolition of the trade-through rule rather than by incremental reforms.

Nevertheless, Citadel believes that the SEC's proposal, if adopted, will be a meaningful improvement over the model we have now. Tangible benefits that would accrue on the listed equity markets from the proposed rule include an increase in market transparency and liquidity; a decrease in effective spreads and execution costs; and a dramatic improvement of execution speed and certainty.

Finally, with regard to your question on the SEC's empirical justifications for the proposal, the SEC has correctly recognized the serious weakness in the current trade-through rule, its failure to reflect the disparate speed of response between manual and automated quotations. A proposed or revised trade-through rule by excluding manual quotations would reduce impact of this fundamental flaw in the current National Market System and thereby improve the system.

A number of commentators have pointed out flaws in the SEC's analysis in regard to the question of whether to extend the trade-through rule to the NASDAQ marketplace. Based on our own experience trading large volumes of both NASDAQ and NYSE listed equities, we believe strongly that the execution quality of the NASDAQ marketplace is significantly superior to that of the listed marketplace.

In conclusion, let me be very clear about Citadel's position here. We do not believe there should be a trade-through rule. However, the current status quo is unacceptable. If an immediate and complete abolition of the trade-through rule across all markets, over-the-counter, listed and option, is not on the table, then Citadel strongly recommends taking a positive incremental step that, in

our opinion, will substantially improve the execution quality of NYSE listed stocks. Thank you.

[The prepared statement of Matt Andresen can be found on page 62 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Robert H. McCooey, Jr., president and chief executive officer of the Griswold Company, Incorporated.

Welcome.

STATEMENT OF ROBERT H. MCCOOEY, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE GRISWOLD COMPANY, INC.

Mr. MCCOOEY. Thank you Chairman Baker, Ranking Member Kanjorski and members of the subcommittee. Good afternoon. Thank you for inviting me here to testify in connection with your review of the SEC's re-proposed regulation NMS.

I am privileged to be here to share my thoughts, again, before the committee. For those of you who do not know me, my name is Robert McCooey. I am a member of the New York Stock Exchange and one of the agent representatives from the floor to the New York Stock Exchange Board of Executives. In my primary job, I am the president and chief executive officer of the Griswold Company, an agency broker executing institutional orders on the floor of the New York Stock Exchange. I am a practitioner.

Chairman Baker, I am pleased to be part of this group you have assembled here today. I hope that I am going to be able to bring some perspective on the impact of the re-proposed reg NMS as well as insight into why, of the two proposals, alternatives, proposed by the SEC, I favor the market BBO alternative over the Volunteer Depth Alternative.

Over the past few years we have witnessed a great transformation taking place throughout the National Market System. At the New York Stock Exchange alone, change has been a prevalent theme in our business. We have welcomed new management who have brought with them new ideas and a new perspective. Our Chairman John Reed and our CEO John Thain has been singularly focused on listening to our multiple constituent groups and responding with an aggressive approach to meeting customer needs.

A product of this response has been the NYSE's proposed hybrid market initiative. This was created as a direct response to the feedback from our customers. With this initiative, we aim to create a market that enhances choice and best serves the demands of all of our customers.

Some of our customers have asked for speed others require certainty and still others desire the opportunity for price improvement. The Hybrid Market offers all of these options. If they want speed, certainty, and anonymity of execution, they can choose the NYSE's automated execution service, an enhancement to a service that already exists today. If they want the opportunity for price improvement offered through the auction process, they can still employ the services of a professional agent to meet that goal.

The SEC, too, has been actively listening to constituents. I praise the Commission for its thoughtful proposals and for all the hard work put forth in creating the best marketplace for all investors. I share this goal, and therefore I support a Reg NMS where cus-

tomers receive the best price for their transactions while also giving them the benefit of competition between marketplaces. I support a trade-through rule that extends to all NMS stocks, as I believe that creates a level playing field for investors and promotes healthy competition among markets.

In the SEC's most recent trade-through proposal, two options were presented. I support the first of the two alternatives, the market BBO alternative, in which the best bid and offer in each market would be protected. This top of book alternative will promote competition to provide the best bid or offer within a market with the assurance that their quotes will not be traded through. It will also encourage market participants to quote aggressively, to be that best bid in offer in order to be afforded that protection. This will narrow spreads and foster more display liquidity. Market participants have consistently ranked these two benefits of the proposal as two of their top priorities.

I strongly disagree with the second proposal, the voluntary depth alternative, that mandates depth of book order routing which will essentially create a consolidated limit order book, or CLOB, in the marketplace. This alternative, periodically debated and always rejected, harms competition among markets by taxing technology and regulation. One of the great features of the New York Stock Exchange is the interaction between large and small orders. The creation of a government mandated order file would significantly limit customers' ability to achieve the best price as the interaction of orders from institutional clients and individual investors would be dramatically hindered. This bifurcated market where the largest institutions would trade in a different arena than small investors would have a significant negative impact on price discovery.

Furthermore, in a CLOB environment, customers' orders would have to be exposed in the market, making them difficult to trade and more costly to execute. All institutional customers worry about the market impact that their orders will have, especially those in small and midcap stocks. The forced display of these orders in a CLOB in order to receive protection is not in the customers' best interest since it undermines the goal of minimizing market impact. I cannot support a model that does not promote the customer's best interest. Additionally, the cost of this model to investors is unjustifiable. The implementation operating costs would eventually fall on investors, and these costs would greatly outweigh any potential benefits.

I cannot imagine a reason to unnecessarily alter today's highly competitive system that accrues tremendous benefits to my customers and your constituents.

I hope my comments today presented before the committee have underscored the importance of a trade-through rule for all NMS stocks and the overwhelming value of the market MBB alternative versus the negative impact of the voluntary depth alternative in the reproposed Reg NMS.

If best serving investors is a goal that we all share, then we must agree on a comprehensive Reg NMS that guarantees the best price for all investors as well as fosters competition. We must continue to put the interest of investors first and provide healthy, competitive, and robust domestic markets.

I am pleased that the SEC has recognized the value in maintaining the trade-through rule. It is reassuring that we can collectively recognize the value of updating this important customer protection rule as we make significant changes to the structure of the NYC in response to suggestions from our competitors and, more importantly, constructive dialogue with our customers.

I am privileged to be part of this process in creating a better marketplace for all investors and again applaud the SEC for all their efforts.

Finally, I want to commend the work that you, Mr. Chairman, your staff, and the committee has done on this issue. Thank you for the opportunity to speak before you today, and I will be happy to answer any questions.

Chairman BAKER. Thank you, sir.

[The prepared statement of Robert H. McCooey can be found on page 176 in the appendix.]

Chairman BAKER. Our next witness is Mr. Thomas M. Joyce, president and chief executive officer, Knight Trading Group, Incorporated. Welcome.

STATEMENT OF THOMAS M. JOYCE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KNIGHT TRADING GROUP, INC.

Mr. JOYCE. Mr. Chairman, thank you. I apologize in advance; I am wrestling with a cold.

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for the opportunity to participate in this important hearing regarding regulation NMS. I am the chairman and CEO of Knight Trading Group. We manage investor assets of over $3-1/2 billion as well as being the largest market maker in the industry, trading well over 1 billion shares on a typical day.

I commend this subcommittee for its interest in ensuring that the capital markets remain competitive and innovative. Although the SEC's regulation NMS addresses some inefficiencies in the equity markets such as ECN access fees to nonsubscribers and subpenny quotations, we have very serious concerns about its proposal to extend the trade-through rule to all markets. Due to competitive forces and the lack of data supporting such a rule, we respectfully submit that the SEC has not demonstrated a meaningful justification of the proposed rule. As such, we firmly believe that neither of the two alternative trade-through rules, market BBO alternative and voluntary depth, are warranted.

The solution is simple: Require linkages that efficiently connect all markets and ensure that all display quotations can be accessible and executable. If there are efficient linkages, then the need for a trade-through rule on any market is effectively eliminated.

There is no evidence to support the extension of a trade-through rule. In fact, the SEC's data on trade-through rates is nearly the same on the NYSE, which has a trade-through rule, and the NASDAQ market, which does not have a trade-through rule. So it is unclear what is to be gained by instituting such a rule across all markets. Government-mandated paths of trading could have serious unintended consequences and negatively impact the techno-

logical innovations that have served to greatly benefit the U.S. investor.

The driver of this innovation can be summed up in a single word: competition. Competition in securities markets has allowed the typical U.S. investor to now experience trades at blinding speed and at the best price. By forcing all trades to take a similar route and be handled in a similar manner, we will undermine the very foundation of competition. That is the distinctions in execution offerings that motivate the investor.

It is those very distinctions which drive the markets to improve. Rather than a centralized way of trading, the U.S. investors want fast trades, complete fills, minimal impact, superior pricing, and minimal costs. These investor demands force the markets to create and innovate in a highly efficient manner. Too many unnecessary rules create roadblocks and reduce competition.

The reproposal significantly underestimates the cost of instituting the trade-through rule for all markets. No trade-through rule has existed in the NASDAQ market, so firms like Knight will face a significant technology cost burden. The costs of these system and compliance technologies and personnel changes will be significant; yet the benefits of a trade-through rule are minimal. The ultimate costs of investors will also be great as they will inevitably suffer from reduced efficiencies brought about by a centralized mandated trading protocol.

Competition rather than mandatory—rather than regulatory mandates should drive market participants. Unlike a trade-through rule mandate, the SEC's rule 11Ac1-5 is an example of regulation that increases competition. The rule requires market participants to post execution stats, and as a result, rule 5 transparency and comparability of execution, which order routing firms can and do use to make informed routing decisions, has increased competition and pressured markets to become more efficient, greatly reducing execution times and the cost to investors. This is due to competitive forces, not regulatory fiat.

Innovations and increased efficiencies may never occur if we do not encourage and foster a competitive market environment rather than pursuing and expanding antiquated command-and-control methods of trading. An approach such as rule 5 provides a far less invasive and less costly way to achieve the goals of a trade-through rule.

There is no evidence to suggest that a trade-through rule will increase limit orders. Charles Schwab data supports the view that small investors would not benefit from an extension of the trade-through rules of the NASDAQ market as their customers, quote, tend to use limit orders approximately twice as often for NASDAQ stocks as for listed stocks, end quote. A trade-through rule simply will not encourage more limit orders since retail investors appear to use limit orders on NASDAQ stocks, which are not governed by a trade-through rule, more than twice as often than on Exchange-listed stocks. This explains why many large retail-based brokers argue there is no need to extend the rule. And let us face facts. Even though the New York Stock Exchange already has a trade-through rule, large institutional investors do not populate the specialist book with limit orders. They simply don't do it.

In short, these real market behaviors tell us that a trade-through rule will not encourage limit orders. Rather than imposing a trade-through rule at this time, a phased approach to addressing market structure issues should be implemented.

Requiring connectivity would go a long way towards ensuring that investors receive best execution of their orders. Once connectivity and access are established, the SEC would then be better able to determine whether there is a need for further investor protections. If necessary, then a pilot program could be implemented to examine the impact of proposing a trade-through rule.

Knight supports the Commission's proposals relating to limiting access fees, banning subpenny quotations, and locked and crossed markets. Each of these by the SEC will help maintain an orderly marketplace, so we urge adoption of those proposals.

In conclusion, competition fosters innovation and efficiencies, ultimately benefiting the markets and investors. Connected markets and efficient and fair access will do more to benefit investors than a costly unproven command-and-control trade-through rule. Knight recommends the SEC minimize unintended consequences by taking a market-oriented approach that requires connectivity, efficient and fair access, and then later considers whether a trade-through rule is necessary.

Thank you. I look forward to any questions.

Chairman BAKER. Thank you, sir.

[The prepared statement of Thomas M. Joyce can be found on page 166 in the appendix.]

Chairman BAKER. Our next witness is Mr. Kim Bang, president and chief executive officer, Bloomberg Tradebook, LLC. Welcome.

STATEMENT OF KIM BANG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE NASDAQ STOCK MARKET, INC.

Mr. BANG. Thank you, Mr. Chairman, and members on the committee. My name is Kim Bang. I am pleased to testify on behalf of Bloomberg Tradebook. Bloomberg Tradebook is owned by Bloomberg L.P. and is located in New York City. Bloomberg L.P. Provides multimedia, analytical, and news services to more than 250,000 financial professionals in over 100 countries worldwide. Bloomberg News is syndicated in over 350 newspapers and on 550 radio and television stations worldwide. Bloomberg Tradebook is a global electronic agency broker serving institutions and other broker dealers. We count among our clients many of the Nation's largest institutional investors representing, through pension funds and mutual funds, the savings of millions of ordinary Americans.

Bloomberg Tradebook specializes in consolidating what has otherwise been a fragmented marketplace by increasing transparency and by providing direct market access to those points of liquidity. We are not competitors of the exchanges; we are liquidity agnostic, if you like. Our challenge is to provide the best possible tools to our clients to empower them to find the best price, whether it is at the New York Stock Exchange, NASDAQ, or any of the other 40 exchanges we route to globally.

Currently the trade-through rule protects manual markets by mandating that investors pursue the advertised theoretical best price rather than the available firm price. The rules should be abol-

ished. If manual markets are to continue on the New York Stock Exchange when they exist at no other significant exchange in the world, they must earn that position as a result of competition, not because of regulatory protection.

We would respectfully submit that the goals of the National Market System can be most fully and efficiently realized with greater transparency and unintermediated access to firm quotations. Greater mandatory display of liquidity beyond the national best bid and offer, the NBBO, and immediate electronic access would make for a more competitive National Market System.

Decimalization has been a boon to investors and an enormous spur to market efficiency. This committee has played a critical role in producing this market evolution. However, the rules governing the display of market data, rules crafted in an era of eighths and sixteenths, have never been updated to reflect this change in decimalization.

Since decimalization introduced 100 price points to the dollar in place of the previous 8 or 16, the amount of liquidity now available at the NBBO is much smaller than it was before. As a result, there has been a dramatic decrease in transparency and liquidity found at the inside quotation. The Securities Industry Association in commenting on Reg NMS accurately observed, beginning quote, "The value of the NBBO, the cornerstone of the market data system, is less than it was prior to decimalization. We believe that the SEC has the responsibility to address this issue in light of the operation of its quote and display rules," et cetera, end of quote.

We agree. Bloomberg publishes data on en route orders to equity securities markets throughout the world. Every significant market other than the New York Stock Exchange and Mexico currently publishes realtime quotations at a minimum of five levels deep for all investors to see and immediately access electronically. As the largest equity market in the world, the New York Stock Exchange should not continue to deny investors and fiduciaries that same transparency and access.

Rather than introduce a new trade-through rule, we believe the Commission should consider amending the limit order display rule to require exchanges, market makers, and other market senders, including ECNs, to publish any customer limit orders within 5 cents of their best published quotations; to require all market centers to have their published quotations, not just the top of file, be firm and immediately touchable electronically.

Three, amend the vendor display rule to require vendors such as Bloomberg to carry the depth-of-book quotations on the same terms as top-of-file quotations.

Four, review and implement with appropriate modifications the New York Stock Exchange open book and hybrid market proposal before making decisions on Reg NMS.

And, fifth, enforce meaningful compliance with fiduciary standards by brokers and investment managers so they use their reasonable means to seek best execution for clients.

This is a modest proposal. As a policy matter, it is hard to argue that decimalization should leave investors with less transparency and liquidity. The impact of simply updating the display rules could be profound, positive, encouraging the display of limit orders

in a fashion that relies on market forces instead of governmental regulation. It is far less intrusive than a trade-through rule which would be expensive to implement and difficult to monitor and enforce.

With better transparency and access to market quotations, brokers and investment managers would have powerful incentives particularly given their best execution duties to reach out for the best prices available in any market, which would improve execution quality, promote intermarket competition, and lower transaction cost.

We think the New York Stock Exchange, in fact, has made some very encouraging progress under the constant and effective prodding on the investors and the SEC. Its open book proposal has some shortcomings, we believe, but if implemented properly, it would enhance transparency. The hybrid market proposal and its direct plus element offers enhanced electronic access to the published quotations. Both of those developments represents a welcomed modernization of the market, and we think the Commission should pause to let them be properly implemented before given further consideration as to whether a trade-through rule is necessary or indeed desirable.

As to market data itself, the chairman of this committee has observed that market data is the oxygen of the markets. Ensuring that the market data is available in a fashion where it is both affordable to investors and where market participants have the widest possible latitude to add value to that data are high priorities. According to the SEC, the SRO networks spend about 40 million on collecting and disseminating market data, and in return receive over 10 times that much in revenues, 424 million. And those revenue come from investors.

We believe the SEC was closer to the mark in 1999 when it proposed market data revenues should be cost-based—excuse me, and that—and its current Reg NMS proposal, which sets forth a new formula for dispensing market data revenue without addressing the underlying question of how to effectively regulate this monopoly function.

Regulation NMS is a bold step to bring our markets into the 21st century. This committee and the SEC are to be commended for prompting what has already been a productive debate. Elimination of the trade-through rule, restoring the transparency lost to decimalization, coupled with greater efforts to ensure access to liquidity, and finally control the cost of market data would help promote a National Market System that best serves investors. Thank you.

Chairman BAKER. Thank you, sir.

[The prepared statement of Kim Bang can be found on page 89 in the appendix.]

Chairman BAKER. And our next witness is Mr. Robert Greifeld, president and chief executive officer of the NASDAQ Stock Market, Incorporated. Welcome.

STATEMENT OF ROBERT GREIFELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE NASDAQ STOCK MARKET, INC.

Mr. GREIFELD. Thank you. Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for the opportunity to discuss NASDAQ's views on the reproposed Regulation NMS. NASDAQ supports much of the proposed Regulation NMS, including the restrictions on subpenny trading, the proposed access standards, and restrictions on access fees.

With regard to the SEC's proposal on market data, we support the SEC's liberalization of proprietary market data; however, we believe the quote credit element is seriously flawed and will be gamed by market participants. Examples of this gaming would be flickering quotes, security targeting, market targeting, shredding quotes, and shifting quotes. This will serve to distort market data and increase investor costs.

With regard to the trade-through rule, NASDAQ opposes it because it is not needed. It is costly, and it will not serve the best interest of investors.

We are proud of the market quality experienced by investors every day on the NASDAQ Stock Market. We achieve that high quality without the anticompetitive effects of a trade-through rule. We do not believe that extending the trade-through rule to NASDAQ is supported by the facts and may indeed be harmful to investors.

Reg NMS will allow investors to make distinctions between fast and slow markets. This will help modernize our overall market structure. While repealing the trade-through rule would be a simpler way to achieve a competitive proinvestor National Market System, the advances proposed by the Commission with regard to floor-based markets are a step forward. This proposal is already driving floor-based markets to develop plans to automate. It will enable electronic markets to compete and will offer investors a better opportunity for best execution.

With regard to NASDAQ, the extension of the trade-through rule to our market would be harmful to investors. We are not convinced that the rule would even achieve the SEC's desired goal of increasing the use of limit orders. In contrast, we know that the rule will, in fact, impose financial and technical costs and deprive millions of investors of the ability to determine what is best for them.

The Commission relied on two economic studies to support the application of the trade-through rule to NASDAQ securities. We respectfully disagree with the Commission's staff studies. Our full analysis is attached to my written testimony, and in these studies it shows that the trade-through rate on NASDAQ is not, in fact, 2 percent, but today is 1 percent.

In general, I will tell you the SEC's study significantly overstates the extent, and it also concludes that differential fill rates for large market orders in NASDAQ and New York Stock Exchange stocks are evidence of a defect in NASDAQ's market structure. This study, in fact, demonstrates a lack of understanding of how the market works, and yet it is used to justify a major change in our market.

Many in Congress have asked NASDAQ what we think of the two alternatives in the latest NMS proposal. Just to be clear, neither a top of book proposal nor a depth-of-book version of the trade-

through rule is better than the NASDAQ open competitive market. The real question should be, has the trade-through rule outlived its usefulness, and should it be repealed?

For those who support a trade-through rule, we found it interesting that the arguments they relied upon conveniently evaporated from their advocacy when the depth of book alternative was proposed by the Commission. In fact, some seem to be taking intellectually inconsistent positions. When the New York Stock Exchange testified before you last February at the New York field hearing, the NYSE stated "Why should investors ever receive anything other than best price?"

There is talk of the importance of speed, anonymity, and other factors, but in a commoditized market like that which exists for equities, if displayed prices across all markets are available immediately, there is absolutely no reason to allow agents to buy and sell on behalf of their clients for anything other than the best price. However, the New York Stock Exchange seems to have had a change of heart. Last month, in a letter to the SEC, the New York Stock Exchange praised the virtue of promoting investors' ability to choose among alternative trading venues and decried the mandatory depth-of-book routing. And it said it will eliminate intermarket competition by giving any limit order regardless of where it was placed the same protection; that is, any limit order would be protected based on price.

If you really worship at the altar of best price, the depth of book alternative fulfills that objective perfectly. If someone supports trade-through protection for one price, how can one logically argue against protection of an order as little as one penny away from that price? That is saying that the first investor in line deserves to have his or her spot protected, but the second person in line and any subsequent investors in line do not.

We have been given a choice between two competing visions. The first vision is the government continues to function as an involved regulator, presiding over the positive forces of competition as is now the case on the NASDAQ market where there is no trade-through rule. Or the second choice is we rely on the government to define quality stock market services and provide attendant rate protection and price setting. This is the world where a national trade-through rule is administered by the SEC.

Some would say there is a level of safety in removing the rigorous jostling forces of competition and applying a government-defined pathway for each and every trade. Others would say competitive vigor is our best hope of providing the most efficient, effective market for investors. I come down squarely on the side of competition, and this is not a theoretical conclusion. The NASDAQ Stock Market operates this way every day and has performed exceptionally well for investors.

In the end, NASDAQ is hopeful that Reg NMS is completed in a timely manner. It is important to move competition forward in the trading of New York Stock Exchange issues.

Again, we hope the Commission will reject the imposition of any trade-through rule on NASDAQ. The Commission's market structure rules are critical to maintaining our lead in the global equity

markets and will impact the way Americans and all investors view the quality and the fairness of our markets.

I thank you for holding this hearing and for considering NASDAQ's views.

Chairman BAKER. Thank you, Mr. Greifeld.

[The prepared statement of Robert Greifeld can be found on page 135 in the appendix.]

Chairman BAKER. And I want to start my questions with you. Based on your obvious concerns about trade-through being extended, setting aside for the moment the consumer interest to respond to this question—and let me quickly add, this should not be considered for litigation purposes a forward-looking statement. I am asking a policy question. If we were to extend the trade-through, or the SEC were to extend the trade-through, with the top of book feature, tell me where the NASDAQ would be 3 years from now. What is it going to look like? What is the bad consequence of that? And take into consideration Mr. Joyce's and others' comments about cost of compliance.

Mr. GREIFELD. Right. I think the consequence is that the trading in NASDAQ stocks remain essentially unchanged, but we have a drag to participants and investors on their return in that the imposition of trade-through on NASDAQ forces all participants to essentially go through a very rigorous and time-consuming and expensive system reengineering to allow each and every participant to follow the government-mandated rules. At the end of that day, you will have some trade-through on NASDAQ even if there is a trade-through rule. So that is a key point. With the imposition of a trade-through rule, there still will be some level of trade-through, and that is specified in Reg NMS.

Chairman BAKER. Well, let me jump in. There is one other issue that the SEC, as I understand it, was hoping to achieve with the imposition, and that was to facilitate enhanced utilization of limit orders. Given where you are vis-a-vis the New York Exchange, what is the prognosis if the trade-through is applied with regard to the current utilization?

Mr. GREIFELD. Well, we see today that there is a greater use of limit orders on the NASDAQ market as compared to the New York Stock Exchange, and we see from a broad range of commenters that they feel their limit orders today are better protected on the NASDAQ Stock Market when compared to the New York Stock Exchange. So we do not have an issue today with investors being wary or unwilling to put limit orders into the market. So, at the end of the day, you are putting a cost structure on to the market, and you are solving a problem that does not exist.

Chairman BAKER. Let me flip over to Mr. Britz and give you the worst situation. Let us say, for example, that the trade-through is eliminated. Now, other than the consequence to the individual investor, who I am sure you will say may not be best served by that change, what is the consequence to the market structure? Assume for the moment the committee's interest in looking forward is to come up with a philosophical approach to the issue to have the most vibrant and competitive market possible in 3 to 5 years. What is wrong with that as far as the New York Exchange, and why won't your predominant position in the market prevail?

Mr. BRITZ. Well, Mr. Chairman, if I may, I would almost like to answer the question for just briefly that you asked Mr. Greifeld. I think NASDAQ will be, under your scenario, a much better competitor of the New York Stock Exchange in 3 years with the benefit of the trade-through rule than they are today. And as you can imagine, I have some mixed views on that, but they would be in a position where they would strive to deliver the best prices to investors rather than striving—having a business model that strives to deliver cash inducements to brokers and substandard prices to investors.

Relative to the New York Stock Exchange, we will continue under all circumstances to have a business model that delivers the best prices to investors with or without a trade-through rule, Mr. Chairman.

Chairman BAKER. So your response really is if we extend the trade-through to NASDAQ, you are actually facilitating their competitive position; and you are going to argue here that in competition for your financial interest is the way we ought to go?

Mr. BRITZ. Yes, sir.

Chairman BAKER. That is an interesting approach.

Let me ask this: Since the numbers are similar as percentages, I go to the question asked by——

Mr. BRITZ. Mr. Chairman, if I may.

Chairman BAKER. Sure.

Mr. BRITZ. The numbers are not similar. There is a fair amount of smoke and mirrors taking place here.

Chairman BAKER. Please explain.

Mr. BRITZ. There is a difference between the gross number and the net number. There isn't anything in the listed market and in the trade-through rule today that precludes a trade-through from taking place; it simply requires a resolution for the aggrieved party. The trade-through rule at the end of the day was not about the taker of liquidity, it is about the person that gets traded through. Ultimately they raise their hand and complain against the trade-through, and that matter gets resolved. So the net number in NYSE-listed trading within the National Marketing System is dramatically different than the gross number that you are hearing about.

Chairman BAKER. And what would that number be? If it is dramatically different, what would be the number?

Mr. BRITZ. Virtually zero.

Chairman BAKER. So are you telling me that there aren't occasions on each trading day where thousands of executions occur which are not at the best price in the market.

Mr. BRITZ. There are always order facts, Mr. Chairman. What I am telling you is that the trade-through rule addresses a procedure whereby those bona fide trade-throughs and aggrieved parties get resolved after the fact.

Chairman BAKER. I understand your point as to process and the right of the aggrieved party to seek redress. My point merely was in today's market function there are on thousands of occasions on a daily basis within the conduct of the New York Exchange transactions, individuals who do not get execution at the best price.

Mr. BRITZ. That is correct. And what I am suggesting to you, Mr. Chairman——

Chairman BAKER. Is there is a way for them to fix it.

Mr. BRITZ. That is exactly right.

Chairman BAKER. I understand.

Mr. BRITZ. That is what the trade-through rule prescribes today.

Chairman BAKER. And all I am suggesting is that the defense of the current structure is that we are protecting individual interest. And I think Mr. McCooey made the point in his written testimony that when we went to decimalization, and there were minor fractions that were gleaned for the investor, we should not lose those fractions of a penny or a penny on the aggregate of trades because of the enormity of value that represents in the market.

I am simply saying—making the same observation with regard to current trade-through practice: There are thousands of occasions when the trade does not occur at the best price, maybe a penny, maybe a little over a penny, and that also represents significant value. And what I am trying to get out of this—and, you know, a Congressman trying to unravel Wall Street conversation is perhaps a more lengthy task than somebody who has only been here 20 years really has to really understand you guys.

But I am kind of getting the picture that, whatever the current system, there are advantages that could further accrue to the average investor—it might be very small amounts—if we let technology work. I think the principal reason—and, again, correct me if I am wrong, one of the principal reasons why the execution might not occur at the best price is the technological barriers between the exchanges that don't allow that transfer of information in a timely manner to meet your own self-imposed trading timelines. Is that a factor in this?

Mr. BRITZ. Proposed Reg NMS, Mr. Chairman, neutralizes the landscape relative to speed. So whatever inefficiencies exist as between so-called manual markets and automated markets today will be a thing of the past under Reg NMS.

Chairman BAKER. But what I am saying, as to current market practice, that is the principal reason I believe that execution may not occur at the best prices, because of technological lack of translators.

Mr. BRITZ. I am not so sure I would call it technological so much as I would call it different market models, different market structures. Technology, the piece of that, to be sure, but a much more fundamental——

Chairman BAKER. We are not getting to the specialist question, are we, with that answer?

Mr. BRITZ. Say it again.

Chairman BAKER. We are not getting into the specialist question with that answer.

Mr. BRITZ. No, we are not.

Chairman BAKER. Okay.

Mr. BRITZ. No, we are not.

Chairman BAKER. I have exhausted my time and probably you as well. I am sorry.

Mr. Kanjorski.

Mr. KANJORSKI. Ms. Dwyer, you helped draft the original trade-through rule, and I assume, because of technological change in advancement, your position now is contrary to what you drafted when you were originally with the SEC?

Ms. DWYER. Well, actually the rule was drafted by the American and New York Stock Exchanges. At that time I represented the American Stock Exchange, and with my companions at the New York Stock Exchange we were being pressured by an SEC that was looking to establish a CLOB because it wasn't happy with the inefficiencies of ITS, which in those days linked regional stock exchanges and some third market makers. And under pressure to avoid the imposition of a CLOB, we did, as Bob has correctly pointed out, create a rule that had nothing to do with best execution, and that rule hasn't had—for at least 28 of its 30 years, it was merely a means of redressing monetary grievances between specialists that traded through each other. It was a means of avoiding arbitration over every single one of those things.

Mr. KANJORSKI. I find that interesting, but I suspect, like Abraham Lincoln, it depends on who you represent as to who you stand for. But your company participates, I believe—and I want to ask this as a question—getting payment for order flow; is that correct?

Ms. DWYER. Well, in some respect I think you could characterize the sale of our market-making business lock, stock, and barrel to UBS with an ongoing order routing arrangement as payment for order flow, but it would then be in the realm of many other things throughout the industry that arguably could be called that, but represent not cash payment for order.

Mr. KANJORSKI. Do you see any conflict of interest involved there?

Ms. DWYER. I actually don't see a conflict of interest there. I see it as the elimination of a potential conflict of interest which we have been managing for many years operating our own market-making business within the Schwab family, and now we have an arm's-length arrangement with the New York Stock Exchange's largest order routing firm and service levels agreements that are, if anything, better than the ones we provided to our customers on our own.

Mr. KANJORSKI. Let me understand, because I really haven't been able to inquire into the question. My understanding is the broker, or the Exchange, but it is really the broker that is handling the transaction, pays the company for its order flow, and then that money reverts back to the company. But it isn't distributed to the investors in that company if their mutual fund buyers or if their investors through that company, those revenues, stay with the corporation; is that correct?

Ms. DWYER. Well, there are many different kinds of payment for order flow, and in some cases monies are remitted back to customers; in other cases, traditionally the SEC has allowed payment for order flow to stay legal because it reduces the cost that customers pay.

In our situation we have a very traditional—today we have a very traditional arrangement on Wall Street, which is paying someone else to execute our orders and being paid for the value of that——

Mr. KANJORSKI. Do you see a big distinction between that practice and insurance companies paying brokers for certain insurables?

Ms. DWYER. Well, I hope you are not going to get me indicted here, but I——

Mr. KANJORSKI. No, I——

Ms. DWYER. I do think there is a big difference.

Mr. KANJORSKI. I can tell you, I have been to a number of exchanges now where the question has been raised to me—and I am flabbergasted—that you all in the securities business don't see the inherent conflict of interest in being paid by the person you are giving the business to, and he is buying perhaps at a higher price which affects your investor. And let me ask anyone else. Do you all see any conflict, potential conflict of interest, or a problem in paying for order flow?

Mr. JOYCE. Mr. Kanjorski, I would like to take a run at that. We at Knight, in fact, do pay some brokers to provide us with order flow. By definition order flows have value, by definition. That is obvious. But any and all.

Mr. KANJORSKI. Well, what is that? It is a payment to somebody—somebody gets the business that you give them because they pay you, right?

Mr. JOYCE. We get order flow brought to us because of, in point of fact, we compensate them under certain circumstances for routing the order flow to us. Now, the point is that——

Mr. KANJORSKI. They used to call that rebates or something in the railroad?

Mr. JOYCE. Rebates. Rebate, payment for order flow.

Mr. KANJORSKI. I mean, this has been a practice going on in American capitalism for a couple hundred years in different forms.

Mr. JOYCE. Yeah. And I think it started in the securities industry in the late 1960s when there were eight-point spreads.

Mr. KANJORSKI. I understand payment for order flow specifically, but rebates and paying for business and the conflict of interest that is inherent in that concept, that has been going on in American business for years.

Mr. JOYCE. Well, I can't comment on the rest of American business. I do know the conflict of interest in this case, I think, is negligible at best because none of these payments take place before the execution is considered. This is all after the fact of securing the absolute best execution for the investor.

Mr. KANJORSKI. But it may cause a worse price.

Mr. JOYCE. With all due respect, Mr. Kanjorski, I challenge that. The best price procedures that are taking place in the NASDAQ—in point of fact, 2 years ago——

Mr. KANJORSKI. You mean you pay somebody money for order flow even though you could have had the same order flow from anyone else and have paid them nothing?

Mr. JOYCE. Or, theoretically, we——

Mr. KANJORSKI. Or they wouldn't pay you for the order?

Mr. JOYCE. Well, we wouldn't have that order flow if we didn't pay for it. We wouldn't just get it.

Mr. KANJORSKI. Why?

Mr. JOYCE. Because we have to—one of the reasons, we get it in competition with other members of the industry. By the way, this is not just an isolated case in one firm or another; this is an industry practice. In order to compete in the industry——

Mr. KANJORSKI. I understand, it is rather broad. Does anyone at that table, eight of you, see anything potentially as a conflict of interest or improper about that activity on the exchanges? And I am just curious.

Ms. DWYER. Let me see if I could answer that in another way. Any business is full of conflicts, and it is how you manage them that matters; do they affect the quality, as you have pointed out, of what the customer receives. So the SEC in this matter has required, I think very properly, that we all do fulsome disclosure to our customers, and that we still be subject to the highest standards of best execution, which we demonstrate regularly to all and sundry. And I would like you to look at the disclosures that are made so customers know absolutely.

Mr. KANJORSKI. Unlike the insurance industry——

Ms. DWYER. I think very unlike the insurance industry.

Mr. JOYCE. I agree it is unlike the insurance industry. You can look up right now on the Internet, and you can see what our execution statistics and the quality of those statistics are.

Mr. KANJORSKI. Why would so many brokers——

Mr. JOYCE. The insurance industry does that.

Mr. KANJORSKI. Why would so many brokers——

Mr. JOYCE. We are very——

Mr. KANJORSKI. When I went on to the floor of one of the exchanges, I must have had 25 brokers come up to me and say, Congressman, you have got to do something about this. This is the most immoral, illegal practice, and most conflict-of-interest practice we have ever seen. And we have no alternative but to pay for order flow.

Are they—their idea of this is grossly wrong, or is there something missing in this?

Mr. JOYCE. I don't know where they are coming from, Mr. Kanjorski. I can't speak for them.

Chairman BAKER. And let me say, that might be the gentleman's last question, but please feel free to respond, anybody who wants to answer his question.

Mr. BANG. A piece of the problem may tie back to access fees that are currently permitted by the SEC to charge access fees, ECNs to charge access fees, exchanges charge access fees. And as a result of those charges, competitive pressures essentially make it such that rebates are funneled back to market participants for posting bids and offers. Our position, Bloomberg Tradebook's position, is that it is a market-distorting element and that we should do away with access fees.

Mr. KANJORSKI. Your position, you should do away with the payment of order?

Mr. BANG. Access fees, which access fees is an element that provide the ability to pay for limit orders. If you eliminated access fees, the ability to pay rebates for limit orders would diminish significantly.

Chairman BAKER. Mr. Greifeld, did you want to add?

Mr. GREIFELD. Yeah. I think the broader issue is a conflict between acting as principal and agent. And our industry really has had to grapple with that through the years, where you have traders who can act both as principal and agent. And most notably in the recent history is the specialists on the New York Stock Exchange, where they did a very good job for a number of years, decades, and postdecimalization you saw that they were putting their principal interest ahead of the customer interest, and that resulted in the $250 million fine.

Now, NASDAQ market makers have also run into problems with managing that principal and agency conflict. I think Carrie says it properly: Conflict is there, it is a question of how the SEC, the SROs discharge their responsibilities to make sure that conflict is managed.

Mr. JOYCE. And if I just may clarify. Knight Trading Group neither endorses nor opposes payment for order flow. It is simply a function of the competitive environment. What we do feel exceptionally strong about is that the retail investor has never had it so good. So any and all payment for order flow issues are above and past the execution issue, because the execution issue is one that is public, and we are exceptionally proud that the retail investor gets top-flight executions, and then the payment for order flow issue comes in. But we neither endorse it nor oppose; it is just sort of a competitive part of life, and it does not, repeat not, affect the quality of the execution.

Mr. MCCOOEY. As a pure agency broker, the Griswold Company sees the conflict and does not pay for any order flow.

Chairman BAKER. Mr. Fossella, did you have a question at this time or comment?

Mr. FOSSELLA. Thank you, Mr. Chairman. Thank you, panel.

Just to follow up on Mr. Britz's comments. I guess I don't—I guess I will paraphrase it. But I think he said that the Reg NMS, I guess, will neutralize the differences relative to the speed of execution among the exchanges. Given that, if that is true, is there anybody on the panel who thinks on balance that a Reg NMS as currently proposed is bad for the markets and thus bad for investors, or does everybody believe that on balance Reg NMS is good for the markets and thus good for investors?

Mr. JOYCE. I would be happy to comment. I think parts of Reg NMS are good for investors, like getting rid of subpenny trading and limiting access fees. It is a fundamental difference that I guess some of us have. There is a view that regulation, i.e., extending the trade-through rule, is going to enhance markets. I fundamentally believe that regulation stops innovation. Long-term innovation will improve the investor experience. So as long as Reg NMS includes an extension of the trade-through rule, it will be, in point of fact, a detriment to the investor experience.

Mr. FOSSELLA. Is there anybody who believes that it will be a detriment? If not, is it safe to assume that everybody thinks that, on balance, as currently proposed, it is a plus for the markets and thus investors?

Ms. DWYER. I think, speaking for me, I think I testified to the opposite, that, on balance, it would not be a benefit. I would say—before I came here, I looked at some order execution statistics from

our own order flow in the last week, and, contrary to Bob's assertion that we would normalize speed in this market, last week, for example, New York Stock Exchange executions, which were of an equal quality of execution that we received elsewhere, were on average four times slower. And I think what I said in my testimony—across all bands of orders. And I think what I said in my testimony was that that kind of a break on the current trading process, something that clogs the pipeline and slows it down.

If you think about the fact that a firm like ours sends probably 40,000 orders an hour out into the markets to be executed, you start to put a drag on that pipeline, and it is not just one investor who may get an execution for seconds, you know, slower or faster, it is the cumulative effect on that entire stream.

Mr. FOSSELLA. And that is currently—you don't feel that, as proposed, Reg NMS will satisfy that?

Ms. DWYER. No. It will make it worse.

Mr. FOSSELLA. Because Mr. Britz followed up, again, different markets, different models, different structures, and different models, that it would be an incentive for these regional markets including the Stock Exchange to become more hybrid, and thus speed of execution will, his point—is to neutralize it. You don't buy it?

Ms. DWYER. Speaking for us, we think the opposite.

Mr. FOSSELLA. Okay.

Ms. DWYER. That the ability—that the necessity to compete fully with more automated markets will cause the Stock Exchange, which is one of the greatest markets in the world, to move forward and innovate.

Mr. BRITZ. If I may, it is inarguable that Reg NMS will normalize the speed across markets in order to have quotes eligible for competition in the marketplace. I don't know at what level right now the language is automatic execution, essentially untouched by human hands. Our own speed for automatic execution is now down to seven-tenths of 1 second. But the point is inarguable that under a Reg NMS regime, speed, or at least some minimum standard of speed, will be normalized across all markets.

I would make one other point relative to Carrie's comment. She was, I am sure, accurately portraying her own firm's data. If you look at the data required to be filed with the Securities and Exchange Commission, you will see that the New York Stock Exchange in a number of trade size categories, for example, the largest trades, is actually faster than any other marketplace.

Ms. DWYER. Bob is correct, I was speaking for us alone.

Mr. ANDRESEN. I think that one thing that is important to note here is that I think the trade-through debate has been mischaracterized as a choice between speed and price. I think that, speaking for Citadel or speaking for any market participant, this is always a choice about price. But there are different factors in price. There is the advertised price of a trade, and there is the true price of a trade. When you buy an automobile, you have delivery charges, you have taxes that might impact the true cost of execution that may very well differ from the advertisement you saw in the newspaper.

And when we talk about normalizing execution costs between exchanges with Reg NMS, the possibility here is to face each—before

each exchange a binary choice to either be a manual market or an electronic market. Once you are in an electronic market, one of the most major implicit costs of execution on the floor of the New York or the American Stock Exchanges disappear. That is the optionality for someone trading their own account to selectively trade with that incoming order. Once that choice is removed, and they must immediately execute that trade or immediately not execute that trade, then the incoming order cannot be gamed. And that—if that is the case, in someone's manual, whether they are seven-tenths of a second or seven-tenths of a millisecond, as long as the gaming is gone, then an investor can take those costs into effect when choosing their routing table.

Mr. JOYCE. If I may just say, normalizing to me sounds like appealing to the lowest common denominator, which sounds like to me a complete lack of competition, which sounds like to me a detriment to the investor community long term.

Mr. GREIFELD. When we think about Reg NMS, when we started this process, we truly had hopes and dreams that it would represent a true step forward for the U.S. equity marketplace. So I guess I take some issue with saying is it detrimental. I believe that is not the right question. It is a question of are we doing this once in a generational change to the markets, and are we taking best advantage of this opportunity.

There are things in Reg NMS, as I stated in my testimony, that clearly improve the markets. But when we look at the imposition of a trade-through on NASDAQ where there is no discernable benefit and there is substantial cost, we are wondering if we really are spinning our wheels and wasting our time for this really unique set of opportunities.

Chairman BAKER. The gentleman's time has expired, unless there is somebody else who wants to respond. If not, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

I am still trying to get my arms around this whole issue. I would like to ask the panel, which of you would like to go away with the award for having lousy testimony, having little effect on the committee, but having been the fastest in delivering it? No takers.

I remember a couple years ago I got a hip replacement, and I was talking to a whole bunch of different surgeons about it. One had told me that he was renowned because he could do six hip replacements before noon. He wasn't that good at it. I went with the guy who could do three but was an excellent surgeon. I think for me anyway it was the right choice. It might not have been the right choice for everybody. I mean, some people just don't want to be on the operating table that long. But that should be their choice.

I remember when I was a teacher, we used to have questions like, two planes leave New York for Washington at 3:00; one travels at 400 miles an hour and crashes and burns upon landing. The other travels 250 miles an hour, gets there 15 minutes later, safely. If I would ask my students which plane would they rather be on, I think they all get it right.

Is there an application of these things to what we are talking about now?

Mr. BANG. I would like to comment briefly on that. We believe that investor choice is really the cornerstone of the creating a competitive, dynamic marketplace. The problem what we have right now is that there is no true choice, because customers, clients, investors do not have the ability to see available liquidity and access it without being intermediated by a manual process. And that means they don't really have the choice between opting in for an option process, let us say manual execution, and a purely electronic direct market access choice.

We don't favor a trade-through rule, but what we favor is providing that transparency and that ability for the investor to make the choice, go for the direct electronic execution, immediate execution, or choose to go to the auction process in the manual market. But that choice does not exist in today's market structure for the New York Stock Exchange.

Mr. MCCOOEY. I am sorry, but, yes, it does. We have an automatic execution at the New York Stock Exchange. We have had it for years. Right now the average trade size is 399 shares at—and—across all listed securities at the New York Stock Exchange. That is the average print size, the trade size. Our execution facility direct plus is 1,100 shares and under. So it encompasses the 399 shares that is the average share size, and that is an automatic execution. There is no human intervention. That is, the order is there. There is an offer that wants to be taken, a bid that wants to be hit, the investor hits that bid and immediately is removed from the screen, and there is no human intervention. So that is a mischaracterization on how the market works today.

Mr. BANG. The markets are capped. There is a trade size cap to up to just a little over—under 1,100 shares. And you can only repeat that process every, I think, 15 or 20 seconds. So there is a speed bump, if you would like, along the way.

With the proposal, hybrid market proposal, from the New York Stock Exchange, they are proposing to do away with that, and we commend that. But as it is today, it is capped in both time and size, and there is no realtime visibility beyond the top of file. So one penny below, you have no visibility and no access to that liquidity.

Mr. ACKERMAN. What is the object of an investor?

Mr. BANG. To get done, typically.

Mr. ACKERMAN. To get done? I had this house I bought, and as I was looking around for painters, I hired this painter, I said, I have got to get this done in 3 days. I got there at the end of the second day to see how he was doing, and he was wrapping up. There was paint pouring down the exterior brick walls of the house, the inside had paint all over the floors and everything. And I said, you messed up my whole house. And he says, yeah, but I finished in 2 days.

Mr. JOYCE. Ah, but the wonderful thing is you had choice. The wonderful thing is, in that example, you had a choice, and you made it. And the way this is—the way NMS is laid out, there will be a limitation of choice.

Mr. ACKERMAN. But if my choice was to get the painter out of there faster, I could have shook hands with him the day I met him and sent him home.

Mr. JOYCE. But at least you had a choice.

Mr. ACKERMAN. The object that I was gunning for was to get my house painted. I would think that the object of an investor—and correct me if I am wrong, but if I am an investor, I am investing money with the object of making money. And if somebody says to me, you are going to lose money, but you are going to lose it faster, you know, is that what the investors are looking for?

Mr. BRITZ. Congressman, if I may. If your question is one more of whether or not, from a public policy point of view and the health of our U.S. capital markets, unleashing this raw speed to the traders, who have great a appetite for it, will ultimately serve U.S. capital markets, the jury is going to be out on that for sure as to whether or not that injects increased volatility into the marketplace.

When I broke into this business 30 years ago, it used to be that behind every order that came to the New York Stock Exchange was someone looking at a balance sheet and an income statement and doing some fundamental work, and then coming to a conclusion and sending an order to our market or anyone else's market. Regrettably, Congressman, that is a very quaint notion today. People simply trade on a momentum basis. They cancel. The cancel rate for orders that are sent to the New York Stock Exchange, the so-called manual slow market, is about 80 percent of all orders that are sent to us are cancelled. And an extraordinary percentage of those are cancelled within the same second that the original order is sent to us. So what becomes of all of this endless speed vis-a-vis the health of the U.S. Capital markets is a question that I don't think anybody can answer right now.

Chairman BAKER. And that is the gentleman's last question, but if anybody else wants to respond?

Mr. GREIFELD. I just wanted to say that this Reg NMS debate clearly has gone on for too long, because I do remember the house painting analogy I guess it was a year ago, and I chuckled at it then, I chuckle at it now.

Just a comment I will make. With NASDAQ, it is not a question of speed versus price. You truly get both speed and price. And by any objective measure, today the NASDAQ Stock Market yields a better outcome for investors than the New York Stock Exchange.

Chairman BAKER. The gentleman's time has expired. If no one else wishes to comment on that question——

Chairman BAKER. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Assuming for the moment that best price is what the consumer is looking for and assuming for the moment that, be it through regulation or legislation, we should impose this, I was reading in Ms. Dwyer's testimony that in the New York Stock Exchange you can have a delay between 30 seconds and 2 minutes on order execution and that the price volatility obviously can cause an investor, under the trade-through rule, not to actually get the best price. My guess is, Mr. Britz, here in part of your testimony that you disagree with that factual assertion. If so, where has she gotten her facts wrong?

Mr. BRITZ. Congressman, I think the author of that disagrees with that.

Ms. DWYER. If you are referring to my testimony—maybe not.

Mr. HENSARLING. I think I was—I guess Mr. Andresen. Maybe it was in Mr. Andresen's testimony. It was in somebody's testimony. I don't think I made it up.

Mr. BRITZ. Congressman, I will take a shot at responding to it.

The average turnaround time for every order that is sent to the New York Stock Exchange across the board, as we speak, is about 12 seconds. I wouldn't deny that there are occasions when it is something north of that by definition. That is an average, so there has to be something north of that.

The facility that we have in place that now handles 11 percent of our volume, the direct-plus facility that Bob McCooey referenced a moment ago, is a sub-second execution which accommodates a multiple of average trade sites, even with the current restriction as to the limitation on size. So any notion that there is a 30-second or a 2-minute execution experience at the NYSE is an artifact, Congressman.

Mr. ANDRESEN. I think that you know one important thing to consider here is the certainty of an execution. Citadel executes over a hundred million shares a day through various venues. If I knew when I was sending an order that I was definitely going to get an execution, I just wasn't going to find out about it for 12 seconds, I really wouldn't care that much. The issue is, if in 12 seconds I might find out that I got, I might find out that I didn't get it.

If I was trying—you know, if I offered you tickets to the Duke Carolina game later this year for $10, you would probably think it is a pretty deal. But if I didn't deliver the tickets until after the game was played, you would not think it was such a good deal.

There is a time value to having the certainty of an execution realized. And we talk about like how quickly we get execution. The real issue here is not just, you know, if the execution is fast. It is, you know, if it happens at all. And especially is there an option for the person on the other end of that line to take advantage of price fluctuations in the meantime. If I send an order and it takes 12 seconds to respond but the stock moved during that intervening time and I only get filled if the stock moved against my order and never filled when it went with my order, then that 12 seconds starts to look like a pretty raw deal.

Mr. BRITZ. Congressman, if I may respond that.

Matt, I don't disagree with the principle you articulated, but I find it interesting that when you trade NYSE stocks, if you trade them away from the NYSE, you have certainty of execution. You get a fill rate on NASDAQ at 59 percent; INET at 18 percent; ARCA, 40 percent; and Brut, 29 percent; versus 79 percent for the NYSE. So who wins the certainty race there, Matt?

Mr. ANDRESEN. Actually, our percentage executions are actually far lower than that. But that speaks to our strategies. When you are standing ready to buy or sell something and you put in an order, that price is good as long as the value doesn't change. When the value changed, you must cancel that and replace it to update what the new price is.

Mr. HENSARLING. Mr. Andresen, let me ask you different question here. And that is, it appears that the ECNs have a much greater market share in NASDAQ traded stocks than they do New

York Stock Exchange. Does the trade-through rule play any factor in this, or what are the factors that account for that?

Mr. ANDRESEN. Well, the most important thing is inertia. The New York Stock Exchange has been around a long time. They have done a very good job with their business. They have over 80 percent market share. If you are going, you know, shopping and 80 percent of the time you find everything you want in one place, you will tend to stay in that place. So, first, you know credit is due to the New York Stock Exchange for their business.

When you look at NASDAQ marketplace, maybe 6, 7 years ago electronic markets had also a very small percentage of volume, but they have been able to be successful there and have not been successful on the New York Stock Exchange. I think part of the reason is the competitive nature of the New York Stock Exchange, but also part of that is the trade-through rule.

Electronic markets attempt to compete using—across various value propositions. There is the cost of the execution—not the price of the trade but the actual explicit cost and fees associated with making a transaction. They offer varying degrees of certainty of execution. They offer different speeds. And the trade-through rule right now, because where there is a better price away your choice as a market is either to match that price internally or route it to that better price. Well, if you are an electronic marketplace that acts as an agent, you are not allowed to trade for your own account. Therefore, your only choice is to send that order away.

Now if you are an electronic market, you are trying to sell services based off speed of execution. But every time there is a superior price you have to mail that off to a different marketplace. You have then lost control of the user experience on that order. And once that happens the customer—and I used to run an electronic network. Now I am part of the problem. I am a customer of these. I don't like that result.

Chairman BAKER. The gentleman's time has expired, unless somebody else wants to jump on in on that. Yes, sir.

Mr. NICOLL. I would just like to remind everybody here that the—a couple of fundamental—I think we need to step back, okay?

We have two markets. One has a trade-through rule; one doesn't have a trade-through rule. Whenever you are considering the parade of horribles that the New York Stock Exchange marches before you about what will happen to their market without a trade-through rule, you have to say to yourself, why hasn't that happened in the NASDAQ marketplace? That's number one.

Number two, you are going to be thrown a lot of statistics which are always in the favor of the person who is delivering them to you.

Let's take this issue that Bob just brought up of fill rates. Fill rates are a consequence of how many executions you get versus how many orders you send. So if you send down 10 orders and you only get one execution, you have got a 10 percent fill rate. If for every order you send you get an execution, you get 100 percent fill rate. Now you would think 100 percent is better than 10 percent. But the fact of the matter is that the better the marketplace, the more certain the marketplace is, the more apt you are to send more orders to them, and the more comfortable you feel sending those or-

ders. Therefore, the better marketplaces don't have higher percentages of fill rates. They actually have lower percentages of fill rates.

Now I am saying that to you because I have a low fill rate percentage. Bob is going to say to you, no, no, my 79 percent is better than his. Okay? I assure you that whoever makes the argument is going to be using the statistics for their own benefit.

I hope you buy my logic. But what I want you to buy, first and foremost, is that these are very sophisticated people up here, what we call on the street, arguing their own book, making the best case for themselves and using very sophisticated arguments to do that. And to me, in a situation like that, the best public policy is to allow competition to play out.

Don't buy into these arguments that you need to overregulate these markets. What we need are minimal regulations. Let these markets compete with each other and let investors choose. Let investors choose which are the best markets.

I assure you the New York Stock Exchange, with its 80 percent market share, all it has to do is meet the needs of investors and it will retain that 80 percent market share. It doesn't need the benefits of the trade-through rule and the barriers to competition that the trade-through rule creates.

Chairman BAKER. I thank the gentleman.

Ms. McCarthy.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

I probably agree with you, Mr. Nicoll. It sounds like Republicans and Democrats when we are trying to sell each one of our points.

I remember when this conversation started, I guess about 18 months ago or 2 years ago, and we first started hearing about trade-through and best price; and now we seem to be, 18 months later, dealing with a situation that in my opinion seems worse than what we started off with. Mainly because I happened to ask the question going back then—I have NASDAQ and I have the New York Stock Exchange, certainly wonderful members of New York, and they add to the economy to, certainly, our great State. But the question kept going back, competition.

If we overregulate, don't think it is going to be good for anybody. But, with that, the one question I still don't get a real answer for, the companies, the investors, the clients are going to go to whoever they feel comfortable with or who they feel they are getting the best service for. So here we are, in my opinion, starting to even more overregulation than what we started off in the beginning, and nobody is happy.

I don't even know how this all started, to be honest with you. I don't have the answers. But I am certainly more confused today than I was before I read all my notes and all the testimony before we started.

So I know it is a separate language down on Wall Street, and it is, and it is a different world. But, you know, we are here, I think all of us, to really try and figure out what is the best thing for the consumer. I mean, that is what we are concerned about in the end. And, hopefully, I think, in my opinion, that we should proceed very cautiously before we make any radical changes.

I think that the rules that are coming through, again, looking at them, and I guess I will ask Mr. Andresen and Mr. Bang, I—from

hearing your testimony, it seems to me that you are suggesting a cautious approach to what Congress and the SEC can judge the impact of any new proposals on the national market. And I guess if your answer is yes—or if it is no, tell me differently. To me, the market and the BBO alternative seems to offer the more cautious approach. That is my—from hearing everything, between those—between NASDAQ and the New York Stock Exchange and all of you in between. And correct me if I am wrong or give me suggestions on where we should be going.

Mr. ANDRESEN. You are absolutely correct. The BBO alternative is the more incremental approach. But if you look at the NASDAQ example, right now there is no trade-through rule. The BBO, alternatively, merely says, well, you have to look at the best price from a competing marketplace. Depth of book says that if someone displays all of their orders, whether it be the best price, the next-best price, the next, next-best price, you must consider all of those. So, naturally, if we are concerned about the costs and unintended consequences of additional regulation, then making someone look at one order versus a potentially infinite number of orders, it is clear which one is less invasive and less apt to have unintended consequences.

Mr. BANG. You are basically correct that we do favor a phased or cautious approach, particularly because the New York has two proposals out there that we think will have significant impact on the way market structure evolves. New York's open book proposal, which is essentially to extend in real time transparency beyond just top of file, which we think is very significant; and, secondly in the hybrid proposal which has this element of extending the direct plus, direct immediate access capability without any share limits and without any time limits. That goes also beyond just the top penny quotation.

Once that happens—although, you know, there are some technicalities with both of those proposals that we have some issues with, but that can be debated and sort of sorted out. But once that happens, investors will have much greater choice. They will have choice to route and go for this electronic, unintermediated approach for an execution, or they will have the choice to go through the auction process.

And we believe that market participants today have very sophisticated execution management systems. They have linkages to these various points of liquidity, and bandwidth is very cheap, and there are smart routers that are designed to get best execution, which in most cases are always best price. It is, you know, not the speed issue. It is a best-price issue.

So, yes, we do favor a phased approach. Once you go through those steps, however, we don't think there is any need for any sort of trade-through rule, whether top of file or depth of book.

Chairman BAKER. Will the gentlelady yield on that point? I just want to echo one perspective of her comment in going slow.

I would think going slow would be to take most of the recommendations made, if that would be the committee's wisdom, and not extending the trade through the NASDAQ. To me, that is just as Draconian as repealing the trade-through rule for the New York. There ought to be some mid-ground here.

I think taking the old western style of ranching and applying it to the modern dairy doesn't make a lot of sense until we get all the pieces sorted out. And I just want to commend the gentlelady's observations and say to her, unless she has further comment——

Mrs. MCCARTHY. Well, taking on that point and just explain that to me, because it seems to me that NASDAQ does not want to go through the trade-through rule and the New York Stock Exchange wants to go through the trade-through rule but doesn't—probably doesn't like the—I lost it here. So neither one of them like——

Chairman BAKER. There is enough wrong here to go around for everybody, yeah.

Mr. GREIFELD. We are certainly not in favor of the trade-through rule.

And going back to your original comment, how did this come about? It came about that investors recognized that something was broken on the floor of the stock exchange in this decimalization world. And there was a hue and a cry to bring about some reform.

They are the only floor-based market essentially left in the world. So, as the rules were put in place to encourage them to automate it, automate their markets, the rules then were extended to NASDAQ. NASDAQ is already an automated market, already has a fast and efficient price discovery mechanism, and we are left wondering why do we bear the burden of the cost for a market that already works so well.

Mrs. MCCARTHY. Well, then going back to the New York Stock Exchange, is actually, because competition is actually moving everything to faster time, correct?

Mr. BRITZ. Correct, Congresswoman.

Congresswoman, if I may, I don't know whether this will bring you the clarity that you seek, and it probably won't, but of the 130 respondents to the SEC across all market participants on reg NMS, 100 were in favor of keeping the trade-through rule in New York, extending it to New York. It breaks out 92 top of book market BBO, if you will, and 8 depth of book. And another five were in favor of the trade-through rule tied to the NBBO, which is more closely aligned to some trade-through rule than it is none at all. Only 27 out of those 130, again across a broad constituency, were in favor of eliminating the trade-through rule.

Chairman BAKER. The gentlelady's time has expired.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

Mr. BANG. Can I get one quick comment?

Chairman BAKER. Sure.

Mr. BANG. A middle-of-the-road opportunity may be to take the proposed reg NMS which is looking at firm quotations and extending transparency to five levels deep, which is nothing more than restoring transparency that was lost to decimalization. And then investors will then chose and route accordingly.

Chairman BAKER. Gentlelady's time has expired.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman; and congratulations on putting together an excellent panel. I see a lot of familiar faces out there who have compiled this panel before on a number of occasions. We have always enjoyed your expertise and good cheer. This

is, what, your fifth or sixth hearing, Mr. Chairman, on the new market system?

Chairman BAKER. I have lost count.

Mr. OXLEY. Somewhere around there. Who is counting when you are having fun?

Chairman BAKER. I will say, though, I note this one wasn't nearly as entertaining as the field hearing in New York.

Mr. OXLEY. Well, I am so sorry that I missed the field hearing in New York.

Chairman BAKER. It was real entertainment, I have got to tell you. I think we need to go back.

Mr. OXLEY. Yes, we do.

And our good friend, Mr. Andresen, I noticed talked about Duke and North Carolina versus Duke versus Maryland, which I thought was——

Mr. ANDRESEN. We don't talk about that.

Mr. OXLEY. I didn't think you would want to pursue that subject.

This—I guess we are here today, and the whole issue revolves around, and I would be interested in the comments from the panel, two relatively recent phenomena that have affected the market. One, obviously, is technology, IT technology, and what technology can do in terms of accuracy and speed and productivity and all of that. And, secondly, of course, was going to decimals. Have I missed anything? Is that—are those the two issues that are driving this whole debate? Is there any other—does anybody want to pile on or add anything else? Okay.

And I think this Committee can take some credit for certainly the second—the decimals, which we finally joined the rest of the world in trading in decimals, and Mr. Andresen still has his famous penny somewhere I think that provided visual aids for the hearing a few years ago. That really did, I think, change the whole equation for all of us as policymakers, for you, market makers and participants in the most robust markets in the world. To that end, there is no question we wouldn't be here today discussing the proposed rule by the SEC had it not been for those two phenomena.

Given that and where we are today, it just seems to me that both the advent of technology and the change to decimals have made this a much more vigorous competitive marketplace. And the entry of ECNs, the NASDAQ's coming of age, all of these changes have meant one thing and that has been an incredibly competitive marketplace that has benefited all of our constituents, those folks who are participating in the market, either directly or indirectly, and it has had an enormous impact on our country and our society.

Over half of the households today are invested in stocks. Ninety-five million plus own mutual funds. People are trading on the Internet. Some of the debate we are going to have about Social Security individual accounts in many ways will involve the arguments that we have got today in terms of people's ability to make decisions in the marketplace for their own future. The ability of those people to amass a fairly good nest egg over 40 or 45 years of saving and investing, the safety of the market, the cost of setting up these accounts, all of these issues and more really bring us to where we are today.

What if—and I will just ask each one of the panel. I have got a pretty good idea where you are coming from. But let's say that, instead of the trade-through rule, that we say to the SEC, let's go back to the old fiduciary duty that brokers and investment managers owe to their clients, including the duty to obtain the best execution of their clients orders, and that we allow this unfettered competition to take place, we allow people in the marketplace to determine whether speed is their thing or whether best price is their thing or a combination—however. What would be wrong with that approach going forward, given these incredible changes that have taken place in a relatively short period of time?

Also, understanding that we as policymakers, whether we are in the Congress or the SEC, many times find ourselves following, not leading the changes that take place in the markets; that, in fact, in the case of Gramm-Leach-Bliley, we were essentially making a law that in many cases out in the real marketplace had already taken place because of technology, because of things that had happened in the marketplace—and so I don't think we are smart enough as policymakers to see into the future, and the only thing that happens is some—most of the time you get it wrong.

So what is wrong with going back to this whole idea that, instead of this intrusive government regulation, we simply go back to the tried and true concept of best execution of the clients' orders which ultimately is their fiduciary responsibility.

Let's begin with Mr. Nicoll.

Mr. NICOLL. Well, I couldn't agree, first of all, that fiduciary responsibility exists today and has existed and will continue to exist. So the trade-through rule, these rules are on top of those existing fiduciary obligations which are established both in common law and enshrined in the SEC regulations. We already have that fiduciary responsibility imposed upon all of the agents in the marketplace. What—and when we started out this debate, we started with that issue.

People said, well, if we have a trade-through rule, then people are going to take advantage of it and trade through for their customers and it will be unfair. So the SEC initially came up with this idea of an opt out and said, okay, in case there are unscrupulous people out there, if you want to trade through, you have to absolutely opt out. You have to say to your broker, I want to opt out. Okay. So now there can be no question with an opt out that people who are trading through are doing it in the interest of their customer.

Well, when that happened, people said—people still wanted a trade-through rule. And so they shifted the argument. They no longer said that it is about protecting the person placing the order. They made this very complicated argument about limit order which said it is not about the person placing the order, it is about the order that is already there. That order that is already there might get traded through, and people will lose confidence. That order that is placed is important because limit orders are important to what is called price discovery, and what that really means is it is important to narrow the spreads between the bids and the offers.

The problem with that argument is it is just not supported in evidence, and there is a lot to suggest that all that you need are

a couple of simple rules of transparency and access. And, by the way, and surprise, surprise, people will not trade through better prices if they can get a better price. It is not a surprise that people seek the best price in the marketplace, and people do not trade through. The evidence that the SEC has already adduced with respect to the NASDAQ has shown that there are very little trade-throughs, and the NASDAQ says that the SEC evidence even overstates how many trade-throughs there are.

So this is all about this sort of bizarre notion that there is this public good in these existing limit orders and if we don't protect them they are going to get traded through and that will impair the quality of the market. It is an interesting story. But, as I said, in my testimony, the facts just don't bear it out.

And nobody talks about the—when they make this argument about this, they will always talk about the future. It is always in the future, okay? But they never talk about the facts. The fact is, we have a market without a trade-through rule and we have one with a trade-through rule; and there is not a whole lot of difference in the number of trade-throughs between those two market places. Whether it is 2 percent or 1 percent or even 0 percent, there is very, very little difference. I would suggest to you that all that we need is that fiduciary responsibility to get the best price and let markets compete and we will have sufficient protection in the marketplace.

Chairman BAKER. Thank you.

Mr. Britz?

Mr. BRITZ. I would say to Ed, if you wear your seatbelt, why would you be worried about some sort of a prescription that requires you to wear a seatbelt?

Congressman, more directly in response to yours, I think you cannot consider this in a vacuum. We don't have a blank sheet of paper here.

Congressman Kanjorski has left us, but earlier he was voicing concerns relative to other things that are in the marketplace like payment for order flow. Payment for order flow and the lack of trade-through rule is a prescription for a bad price. Best execution is—I have yet to hear anyone clearly delineate what best execution means. It is a very broad, to use your word, fiduciary principle. And it is, at best, after the fact proved that you have gotten your customer best execution, whereas trade-through rule insures that you will get them the best price in real time.

You know, I think, Congressman, through SEC hearings and congressional hearings and SEC concept releases and rule proposals we make this much more complicated than it needs to be. If you are a market destination that runs your business to deliver to investors the best prices, your best friend is the trade-through rule. On the other hand, if you are a market destination that runs your business off a business model that is based upon inducements to brokers and inferior prices for investors, I do understand why you would have a problem with the trade-through rule. What I don't understand is why you would think that that kind of a business model is worthy of relief from this body vis-a-vis the trade-through rule.

We talk about—there is a lot of "don't overlegislate and competition." the folks who are here talking about the trade-through rule are asking you for relief from a rule that requires them to provide investors with the best price. Competing on the basis of other than the best price in a world where speed is neutralized, I don't understand that kind of deregulatory competition.

Mr. OXLEY. Thank you.

Miss Dwyer.

Ms. DWYER. Chairman Oxley, I think a lot of folks at the SEC where I used to work had an unofficial motto when they taught about rulemaking which was, first, do no harm. I think, as Ed has said, we have two models in front of us, one with a trade-through rule and one without. The one without is wildly competitive, produces, you know, equal order execution statistics to anything that the vaunted specialist system can produce, sometimes a lot better. I think we ought to be guided by what we see in front of us in terms of what works and what doesn't and be very careful about layering, you know, protectionist rulemaking on top of a market where two and a half billion shares a day pass through it. It is fairly fundamental to the health of our economy.

There are conflicts everywhere. We have to continually strive to manage them better, even on the floor of the New York Stock Exchange, as we have seen in the last few years.

Do we have suboptimal performance? I think that allowing the markets to work freely, possibly even being incremental—the SIA, which represents the majority of the securities industry, has commented against the trade-through rule and has proposed something that I think was very ingenious which, as a compromise, would be an exemption from the trade-through rule across all markets for highly liquid securities that obviously don't need one. Something to think about.

Also, the opt out is very a fruitful suggestion. So that you have a trade-through rule if you feel you need one only where you need to have it.

I think we ought to look at those things before we impose what is a government design on how every single firm operates. I don't think I can explain the trade-through rule to our customers. I don't think it matters to them. They want to look at the price they got.

As we said earlier, I think that the best possibility of getting best price consistently for customers is in a freely competitive market.

Mr. OXLEY. Thank you.

Mr. Andresen.

Mr. ANDRESEN. Thank you. Thanks for bringing up Maryland again. I can't get enough of that.

Well, Citadel, as we noted in our testimony, is in favor of the top of book reg NMS proposal for the listing department. And we do that because we think it puts in front of each of the manual markets a choice, that you either have to be—go ahead and stay a manual market or you have to have your quote be immediately and automatically executed without human intervention. That is Citadel's primary concern.

You know, we talk about, well, you know, best price or you know maybe it is not best price. The thing to keep in mind is that just

because a price is on a screen does not mean that that is the price you are going to get. You might get no price.

You know, the Palm Pilot IPO years ago moved 27 points in the first 30 seconds. That is an extreme example. You can see with, you know, stocks like Taser or stocks like Fannie Mae, when they had bad news, that there are violent moves in securities. In those instances, it is most dramatic when you have big swings in stocks how much money is really at cost here, when there is optionality and time value, to someone deciding whether or not to execute your trade.

What I am excited about with the top of book is, if markets are forced to choose to say, well, competitively, I have to be a so-called fast market, I have to be an automated market, once the price is automated I am less concerned as an investor about getting that price back in a second versus a millisecond. Than I am about making sure I either get it or don't and no one is taking advantage of my order.

Mr. OXLEY. Thank you.

Mr. McCooey.

Mr. MCCOOEY. Chairman Oxley, thank you for bringing up this point.

I think, as the agent here who has this fiduciary responsibility for his clients here every day, I would agree with you. I think it is important for the SEC to take up that mantle with, obviously, the oversight of this committee and to move forward with trying to define best execution obligations.

I think it is very—for us, it is very difficult each and every day to have to deal with brokers and see trade-throughs and see our customers traded through in a way where we are not getting an execution because other markets have traded through us. We want to make sure that we get the best execution we can for our customers, and it would certainly be much easier for us in this regulatory environment, where people have been put into regulatory jeopardy over the past number of years, to have a better understanding of what the SEC does define as best execution. So we would support that, and we think that that is something that this committee should encourage the SEC to take up.

Mr. OXLEY. Thank you.

Mr. Joyce.

Mr. JOYCE. Chairman Oxley, just as an observation, Mr. Britz keeps referring to inferior prices to investors as some business model that I think he has referred to two or three times today. I get a sense it is a veiled shot at NASDAQ. Perhaps it is. Perhaps it isn't.

In any event, I can assure you that we trade a lot of NASDAQ stocks, and never in the history of retail investors have retail investors gotten such a good deal trading the NASDAQ stocks or New York Stock Exchange stocks, for that matter, too. And it is because of what you said earlier. There is vibrant competition taking place in the markets, and I think what this committee and what the SEC needs to focus on is maintaining, encouraging that vibrant competition to continue.

As you see the results over the last 2 years, where turnaround times have come down from 20 seconds, in some cases, to sub-sec-

onds now, to people getting the best price they see on the screen, if not an enhanced price, those best-execution responsibilities in a competitive, transparent environment have driven those results.

So I believe, sir, that your blueprint is entirely accurate. A light regulatory touch enhancing and encouraging transparent competition is the only blueprint that this market should pursue.

Mr. OXLEY. Thank you.

Mr. Bang.

Mr. BANG. We believe that change is needed. We believe that leveling the playing field between professional market participants and the investor is really important. That is what is going to promote greater competition and choice for the investor.

For the investor to really have choice, we believe that there needs to be firm quotations in the marketplace, greater level of transparency, at least restoring what was lost to decimalization and perhaps a dose of additional oversight in terms of what the fiduciary obligation of the particular market participants are with regard to best execution.

Now, best execution is not clearly defined, if you like, but there are certainly a number of guidelines, one through the 11Ac1-5 statistics, or through third-party independent performance cost analysis firms such as Abel Moser, Plexus and Elkins/McSherry. All of these attempt to measure the quality of execution, and it is certainly something that is available to investors, particularly, you know, the professional institutional investors. They watch those sort of statistics very carefully, and, based on that information, they decide where to send their orders for execution. But, right now, there is not a level playing field and in that choice certainly, not with respect to the manual markets of the New York Stock Exchange.

Mr. OXLEY. Thank you.

Mr. Greifeld.

Mr. GREIFELD. My comment is very easy.

Mr. Chairman, I agree with your thought, and it is the way the NASDAQ stock market operates today. There is not a trade-through rule. There is not a heavy burden of unnecessary regulation. Our market does not trade through, and it trades incredibly well, and, by objective measures set up by the Commission, namely the -5 stats, it trades better than the New York Stock Exchange.

I think it is interesting, if we flip the scenario, where NASDAQ was the institution that had been around for 211 years and NASDAQ was the electronic market, and the entrant who had been in business for 30 years had the manual slow market, we wouldn't conceive of imposing upon the larger markets the solutions that are intended to fix the smaller market. So we have a situation here where, by all objective measures, the New York Stock Exchange has to move forward based upon technology and based upon decimalization, and there is no clear or compelling case or really any case for imposing their remedies upon the NASDAQ stock market.

Mr. OXLEY. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

I believe I am—well, I guess—I thought I was going to be last, next to last. That doesn't mean I will be brief.

The gentleman from Ohio, I think, reflects wisdom in his question, which is, basically, why not rely on the fiduciary rule and allow investors, perhaps, to specify what they are looking for? Some, as Mr. Ackerman points out, just want the hip replaced as quickly as possible. Others may care about the quality. Some will want a top of the book, others want a depth of book. Some will want to opt out. And I don't always agree with the chairman. It is a joy to do so. I think most wisdom comes from California. And CALPERS——

Chairman BAKER. You just lost the chairman again. I am sorry.

Mr. SHERMAN. I had him for a second—writes us and says we still believe that investors should have an opportunity to make choices and, therefore, an opt-out provision appropriate within regulation NMS. And they go on to say that CALPERS, it looks for best execution, but best depends upon best price discovery, and also they have a number of different objectives—speed of execution, price, probability of trade completion, convenience and, for them, anonymity. So I am a little surprised that an SEC appointed chiefly by the other party, a party that is always telling us to avoid excessive regulation and to allow investor choice is about to, I guess, clash with the right wing libertarians at CALPERS and, I might add, with perhaps its most prominent board member, our treasurer, Phil Angelides, who writes us pretty much along the same lines.

So, again, I am surprised that it would take government to impose one model or the other, in part—I don't see whether investors are crying out for this, and I am going to ask Ms. Dwyer, because I know your company is in a marketing competition. Some brokers are offering, you know, free trades; some will give you a free toaster. Some will give you this; some will give you that. You have got a huge marketing department trying to figure out what investors might want, and you can offer them what they might want, and I recommend the toaster oven. But the—is there anybody in your business that has a plan, a marketing plan, a way you can sign up for an account where they guarantee you top of the book? Has anybody got that as a marketing strategy?

Ms. DWYER. Well, I would answer that by saying I think we already guarantee them much more than that.

Mr. SHERMAN. I know. The SEC is about to put a rigid rule, or one of two rigid rules in place, and I wanted to know if there is—any of your marketing geniuses have discovered a group of investors who want either of these two rigid rules.

Ms. DWYER. No, our customers want——

Mr. SHERMAN. Okay. Is there anybody out there who has come up with a marketing strategy of depth of book? And I realize that might be a little harder to offer, but is anybody offering as close to an equivalent of that as possible?

Ms. DWYER. Not that I am aware of.

Mr. SHERMAN. So they are all offering the fiduciary duty that the chair put forward, that is to say, best execution, and we—none of the marketing geniuses have been able to find a group of investors who want a rigid rule imposed, at least for their own trades.

I wonder if anyone else has a comment on that?

Mr. BRITZ. Congressman, you talk about investor choice. Let's maybe get a little granular here. Supposing you are the investor and supposing you choose to be the best bid and offer in the marketplace. You want to—you have topped the best bid because you aggressively want to buy the securities. And suppose it trades in another marketplace, and you are willing to pay $20, and it trades at $19.90 in another marketplace. Did you choose to get traded through?

There is an old expression, Congressman, it takes two to tango; and there are both sides of that. You would not have opted out in that.

Mr. SHERMAN. It does. The buyer's broker is retained by the buyer. The buyer's broker—hey, if I am buying a house and my—and I retain a broker and I say I don't want one that is purple, great. Well, lo and behold, you know, if the best deal on the block is purple, he won't show it to me. And I would say that if you have got the highest offer on one side and for some reason the broker on the other side doesn't pick you, that is a choice, just as if you have a purple house, my real estate broker has the right to pass you by.

I wonder if we could get some comment on the idea of why this SEC rule doesn't give investors the choice. Because there are at least three choices: opt out, top of book or depth of book. What if I am just fanatically in favor of top of the book and the SEC comes up with depth of book? Will I be given a chance to have my fanaticism reflected in my trading behavior?

Mr. NICOLL. A couple of things. First of all, I ran two large retail brokerage firms before. I now run Instinet. In each one of those instances over the past 20 years I have represented customers in the NASDAQ marketplace without a trade-through rule. It is my responsibility to make sure that I got my customers their price. And if they were traded through, they give me a limit order, I was the one responsible for that. I have the fiduciary responsibility.

So in Mr. Britz—the proper response to Mr. Britz is, if that happened, you would be calling up your broker and say, why the hell are you on the wrong market, you idiot. And you owe me an execution. And, by the way, you would get it. Okay? So we are confusing here the broker's responsibility with the customer's responsibility.

Second, as to why the SEC is proposing what it is proposing, all I can say is that it has been—the market reg apparently has been in love with the CLOB for a long, long time. It has tried to impose it before. It—and each time it does, I think cooler heads prevail.

I think this was another opportunity for rethinking the marketplace; and, once again, the SEC, you know, tended to go towards its roots. I mean, it is a regulator. It believes in regulations. It tends to propose what it believes in, and I just think that it missed the mark. And I don't——

Mr. SHERMAN. Thank you.

I see my time is expiring, but, Mr. Chairman, I would hope that we would bring the SEC before our subcommittee and ask them why they want to deprive those investors who would want to opt out with the opportunity to do so and, also, if for some reason they oppose a depth of book rule, why they would prohibit investors

from choosing a broker who goes with a top of the book rule. I would like to explore why the SEC seems opposed to investor choice.

Chairman BAKER. I thank the gentleman for his perspective and would just say for the record the Commission is bipartisan and it is unclear, quite yet, which members are voting which way. I have my suspicions, but I would not wish to prejudice those positions until they are finally determined.

But let me quickly add——

Mr. SHERMAN. Mr. Chairman, you know the SEC is about to make a mistake when I am trying to give you responsibility for them and you are trying to say that we should take responsibility for them.

Chairman BAKER. I appreciate the gentleman's effort to make it my fault, and I am conscious of his continuing efforts to do that.

But I also want to join with him in his observations that we would—perhaps are losing sight here of something. It is an investor giving his money to somebody. And if the investor chooses to dictate how his resources are deployed, it just seems to me—and I am agreeing with the gentleman, even if he is from California—that there is something basically fair about that. And if we are not getting to a standard of fairness, then we need understand why we are not and how we can without bringing unnecessary adverse consequences to a marketplace where has performed admirably by making reckless change in the conduct of the market.

But it is certainly worth, I think, continued effort on the part of the economy to understand more comprehensively the consequences of this debate today and certainly—and I can assure the gentleman of our renewed interest, and we will return to this subject perhaps more times than most members would like. I thank him for his courtesy.

I wish to express my appreciation to all of you for your long-suffering patience.

Our meeting stands adjourned.

[Whereupon, at 5:46 p.m., the subcommittee was adjourned.]

A P P E N D I X

February 15, 2005

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"The SEC's Market Structure Proposal: Will It Enhance Competition?"
February 15, 2005

Thank you, Chairman Baker. This is the Financial Services Committee's fifth hearing on market structure issues in the past two years, and I have found them all to be quite informative.

As I have stated previously, my approach to these complex issues is governed by a fundamental belief that Congress has an obligation to ensure that no markets have regulatory advantages that inhibit competition and artificially preserve market share.

Today, it is clear to most disinterested observers that the New York Stock Exchange benefits from a regulation passed nearly a quarter of a century ago. I am of course referring to the Intermarket Trading System's trade-through rule, which has allowed the Exchange to preserve its dominant role in the trading of listed securities. Its 80 percent market share is anomalous in an otherwise hypercompetitive industry. For a stark comparison, consider the Nasdaq market, which does not have a trade-through rule: robust competition thrives among Nasdaq, Instinet, and others, and delivers to investors superior trade execution.

As a matter of free market philosophy, the easiest and most efficient solution would be to eliminate the rule altogether. The objective would not be to harm a venerable institution like the NYSE, but rather to inject some much-needed competition into the listed market.

On a practical level, however, trade-through repeal does not appear to have majority support at the Commission. We are then presented with the question of whether Regulation NMS includes enough reform to support under the banner of incremental progress.

My tentative view is that Reg NMS passes this test, with one caveat. The trade-through rule should not be extended to the Nasdaq market, which operates efficiently without one. In my view, no compelling evidence has been presented to justify this aspect of the proposal.

I applaud the Commission for its hard work in preparing this proposal. Although it is not perfect, I have reluctantly concluded that it improves upon the current regulatory framework.

I commend Chairman Baker for arranging such a distinguished panel of witnesses and I look forward to their testimony. I yield back.

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OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?

TUESDAY, FEBRUARY 15, 2005

Mr. Chairman, today we meet for the fifth time in the last sixteen months to evaluate the need for further reforms in the organization of our capital markets. The ongoing deliberations over the National Market System have engendered strong emotions and considerable debate.

As I have regularly observed at our previous hearings, a variety of agents in our equities markets have questioned one or more aspects of the regulatory system during the last several years. Technological advances and competitive developments have also led us to a crossroads in the securities industry, forcing us to confront a number of decisions that could fundamentally alter its organization for many years to come.

One year ago, the Securities and Exchange Commission put forward four interrelated proposals to reshape the structure and operations of our equities markets. After reviewing the comments that it received regarding these matters, the Commission made a number of striking changes to its original plan and republished them for comment this past December.

Mr. Chairman, as you already know, I have made investor protection one of my highest priorities for my work on this Committee. It is therefore my very strong expectation that the Commission, first and foremost, will ensure that it protects the interests of average American investors in any decision it finally reaches regarding the future of the National Market System.

Given my interest in protecting retail investors, I was very pleased that the Commission decided to retain the trade-through rule when issuing its latest regulatory proposal. As one of the foundations of our National Market System, this regulation has ensured that all investors get the best price that our securities markets have to offer regardless of the location of a transaction. The approval of an opt-out provision for the trade-through rule would have likely splintered our securities markets, decreased liquidity, limited price discovery, and damaged our economy.

Today, I also suspect that many of our witnesses will focus on the Commission's newest proposal to alter the trade-through rule. In addition to applying the trade-through rule to all securities marketplaces, the Commission's latest plan for updating the National Market System includes two alternatives for implementation: the Market Best Bid or Offer Alternative and the Voluntary Depth Alternative.

Although some of our witnesses may disagree, the former approach, in my view, is the one that the Commission should choose as it better protects investors, fosters competition between and within markets, and incentivizes markets to attract the most aggressive orders. Also, the Voluntary Depth Alternative seems inconsistent with the goals of the National Market System in that it would undercut efforts to promote robust competition between markets.

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Moreover, the Voluntary Depth Alternative would almost certainly result in only one way for markets to differentiate themselves -- namely, how much they are willing to pay other market participants for their order flow. In my view, promoting competition based on payment for order flow will prove detrimental in the long term to average retail investors because of the conflicts of interest it creates. This issue is one that the Commission should carefully study and one that I hope our panelists will address in their comments and answers today.

Ultimately, the Commission can best ensure that investors obtain the best price by balancing competition between markets with protection of the best prices in each marketplace. From my perspective, the incremental approach contained in the Market Best Bid or Offer Alternative is preferable. The adoption of this alternative will also help to ensure that the United States maintains its global leadership in our financial markets.

In closing, Mr. Chairman, it is appropriate for our panel to conduct continued oversight on these complex issues. The observations of today's witnesses about these matters will further help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets for many years to come.

OPENING STATEMENT
CONGRESSMAN PETER T. KING
before the
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS

"The SEC's Market Structure Proposal: Will it Enhance Competition?"

February 15, 2005

Thank you, Chairman Baker. I appreciate the opportunity to comment on the SEC's latest market structure proposal.

Today's hearing builds upon previous inquires by this subcommittee into of the overall soundness of our capital markets. Regulations issued by the SEC, specifically Reg NMS, have the potential to significantly alter the U.S. equities market structure.

On December 15, 2004, the SEC re-proposed Regulation NMS (National Market Structure) with two alternatives. The first, which I support, is the best Bid and Offer (BBO) alternative which preserves intermarket competition. Protecting the best prices in each market encourages intra-market and inter-market competition which, in turn, attracts the most aggressive orders. This competition within and between markets create low transaction costs and equal protection and choice for small and large investors alike.

The second proposal, which concerns me, is the Voluntary Depth Alternative. This alternative shares many of the characteristics, and problems, of a Consolidated Limit Order Book (CLOB), a proposal conceived in the 1970s and rejected by the Congress and SEC in 2000. This proposed alternative would turn our market centers into mindless order routers. It has the potential to nationalize the U.S. equity markets and remove any incentive for market competition.

Investors in U.S. listed stocks benefit from competition between markets and from efforts made to ensure the best price of a particular transaction. As a result, spreads are among the tightest in the world, and transaction costs are among the lowest. In addition, investors can choose which type of execution they prefer based on particular circumstances or strategy *(i.e. electronic vs. auction markets).*

I have serious reservations on implementing a 100 percent computer-based market system which eliminates human judgment at the point of sale. Our capital markets should be more than order routers because those orders are more than numbers – they're customers with individual needs and goals. That is why the human element is so important throughout the day, and particularly during times of market duress. Specialist and floor brokers offer judgment and expertise in everyday trading. Those skills benefit large mutual fund transactions as well as the 100 shares of IBM that you or I may be interested in purchasing.

I applaud the Commission for its diligence in considering these important market structure issues, and for offering an alternative that promotes competition and innovation. However, I believe the Voluntaty Depth Alternative would have damaging effects on our markets and investors. I look forward to the testimony from our distinguished panel of witness on these proposals.

Thank you, Mr. Chairman.

February 15, 2005

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, "The SEC's Market Structure Proposal: Will It Enhance Competition?"

Thank you, Mr. Chairman, for calling this hearing and bringing this distinguished panel of witnesses before us to share their comments on the Securities and Exchange Commission's (SEC) Regulation NMS proposal.

I share our Full Committee Chairman's sentiments that our market rules and regulations have not always kept pace with technological advancements and applaud the SEC's efforts to provide greater transparency and investor choice for all Americans.

However, when the SEC republished its proposed Regulation NMS in December I did send a comment letter expressing my reservations regarding the Voluntary Depth Alternative to SEC Chairman William H. Donaldson.

I am concerned that the proposed Voluntary Depth Alternative would create a trading system that shares many of the problems of a Consolidated Limit Order Book (CLOB), a concept first envisioned in the late 1970's, then debated and rejected by Congress and the SEC in 2000. This proposed alternative would require mandatory depth-of-book order routing that would turn market centers into mindless order routers and would increase investors' execution costs. The CLOB was rejected by Congress and the SEC previously, for one overriding reason: it would effectively nationalize the U.S. equity markets, removing incentives for markets to compete with one another.

The U.S. equity markets are currently the strongest in the world. Today, we benefit from competition within markets and competition between markets. These competitive forces combine to create low transaction costs, tight spreads, low volatility, innovative price discovery and equal protection and choice for all investors – large and small. Intermarket competition is currently transforming the largest equities market in the world. I am concerned that the Voluntary Depth Alternative would undermine the competitive forces that lead to such market innovation.

I look forward to learning the opinions of today's witnesses on both alternatives put forth by the SEC in December and their probable impact on market competition. Thank you again, Mr. Chairman, for scheduling this hearing and I look forward to an informative session.

STATEMENT OF MATT ANDRESEN
ON BEHALF OF
CITADEL INVESTMENT GROUP, L.L.C.
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

February 15, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, I am Matt Andresen, Co-Head of Citadel Derivatives Group, an affiliate of Citadel Investment Group, L.L.C. ("Citadel"). On behalf of Citadel, I welcome this opportunity to present our views on the proposed National Market System (NMS) regulations issued by the Securities and Exchange Commission (the "SEC").

Citadel manages approximately $11 billion in investment capital from its headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. On average, Citadel accounts for between one and two percent of the daily dollar volume traded on both the New York Stock Exchange (NYSE) and Nasdaq, and more than 10 percent of the daily U.S. listed equity options contract volume. With nearly 1,000 employees, and as an active and substantial investor in the U.S. and throughout the world, Citadel has a vital interest in the development of fair, efficient, transparent and liquid capital markets. Because the trade-through rule implicates fundamental questions regarding the transparency and efficiency of the markets, the issues to be addressed at this hearing are of great importance to all investors. American investors, whether retail or institutional, have a vested interest in ensuring that U.S. markets remain the strongest and most efficient markets in the world.

In this statement, I will discuss Citadel's position with regard to the proposed Regulation NMS, and basic principles with respect to the so-called "trade-through" rule and then turn to the specific issues raised by the Subcommittee, including: (1) the proposed extension of the trade-through rule to all NMS stocks, (2) the top-of-book and depth-of-book alternatives, (3) the consequences if any of these proposals are adopted, and (4) the SEC's empirical justifications for the proposal.

Citadel believes that the existing trade-through rule is unnecessary and should be eliminated. Market forces and robust competition are sufficient to discipline inefficient market centers and ensure high quality executions. One need look no further than the Nasdaq marketplace for evidence of the benefits of competition among execution venues. Nasdaq lacks a trade-through rule and yet Nasdaq stocks exhibit greater liquidity than NYSE stocks, and orders in Nasdaq stocks are executed more quickly and efficiently and at better prices than their counterparts listed on the NYSE and AMEX.

The trade-through rule proposed by the SEC, however, if adopted, would be a substantial improvement over the current regulatory framework. The key components of the SEC's proposed trade-through rule are:

- The ability to bypass manual markets
- The inclusion of an intermarket sweep exception to execute large institutional orders cleanly and efficiently
- The clear definition of what constitutes an "automated market"

Citadel has asked the Commission to act quickly to either eliminate the existing trade-through rule or adopt the proposed rule.[1] In addition, given that the U.S. options markets are plagued with the same market structure problems as the NYSE- and AMEX-listed equities markets, Citadel has requested that the SEC extend its proposed trade-through changes to the options markets.[2]

[1] Citadel has already submitted two written comments with the SEC in response to Regulation NMS: (1) Letter to Jonathan G. Katz, Secretary, Securities Exchange Commission, Re: Regulation NMS-File No. S7-10-04 (July 9, 2004); (2) Letter to Jonathan G. Katz, Secretary, Securities Exchange Commission, Re: Regulation NMS – File No. S7-10-04 (January 10, 2005).

[2] This proposal was included in a petition for rulemaking submitted by Citadel to the SEC to address shortcoming in the options markets: Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Re: Petition for Rulemaking to Amend the Options Intermarket Linkage Plan (January 22, 2005). See Exhibit 1.

REGULATION NMS & THE TRADE-THROUGH RULE

When the current regulatory regime was instituted back in the late 1970's, split-second electronic trading was not yet contemplated. The advent of electronic exchanges and networks has added new criteria of value to the execution process. When everything happened on a floor, the only metric that mattered was the advertised price for a security. On electronic markets, however, additional metrics are considered, such as transparency, speed, and – most important – certainty of execution.

The debate over the "trade-through" rule has erroneously been described as a trade-off between speed and price. This is not the case. In fact, the debate should instead be described as a choice between true price and advertised price.

The markets have changed dramatically in the past 20 years, and much of this change has been driven by technology. As a result, the SEC currently is in the process of reviewing and proposing changes to the National Market System (NMS). As indicated in the SEC's February 2004 Press Release, one of the key questions is whether to continue with the trade-through rule framework and, if so, on what basis. Certainty and speed of execution are important for investors. As a direct result of the trade-through rule, however, investors are limited in their choice of execution venue. Often, attempting to purchase or sell stocks at advertised prices on the NYSE and AMEX results in potential delays of between 30 seconds and 2 minutes. In that time, prices may move many times and the price at which the investor sought to trade may no longer be available. Therefore, the trade-through rule, which seeks to give the "best price" to each investor, can actually cause an investor to get an inferior execution.

If the trade-through rule is abolished, investors would have unfettered choice of markets. Competition among execution venues would lead to lower execution costs and superior service to the marketplace. It is a universally accepted principle in the securities market and elsewhere that time equals risk. Securities prices continuously change to reflect evolving market conditions, and prices change at a rapid price. Consequently, each time an investor's order is sent to a slow, manual market, the investor faces a greater

risk of prices moving prior to execution than the investor would face on a fast, electronic market.

Citadel believes that eliminating the trade-through rule would be consistent with the SEC's "best execution" requirement. The SEC has long defined "best execution" as the duty to seek the most favorable terms available under the circumstances.[3] This definition focuses on a number of diverse factors including not just price, but also speed, liquidity, certainty and other factors. The evolution of the market towards an appreciation of the value of speed and certainty is clear. Even non-institutional, retail investors are learning the importance of speed in cutting their true cost of execution. This is demonstrated by the recent advertising campaigns of retail brokerage firms focusing on speed of execution to attract new customers.

Abolition of the trade-through rule will benefit <u>all</u> investors because, by rewarding firm quotes, slow markets will be incented to improve and upgrade their trading systems and methods. Manual and hybrid markets will have the flexibility to evolve toward the automation they see fit, but would no longer be afforded the unfair advantages that exist under the current trade-through rule. Indeed, the mere discussion of trade-through reform has already encouraged existing manual markets, like the NYSE and AMEX, to begin planning enhancements to their trading capabilities.[4] Citadel applauds this result and believes the elimination of the trade-through rule would only accelerate these improvements to the benefit of all investors.

<u>Comments on the SEC's Proposed NMS Market Structure</u>

(1) <u>The Extension of the Trade-Through Rule to All NMS Stocks (And Discussion of Extension of Trade-Through Rule to Options Markets)</u>

Citadel does not believe that a compelling case has been made for the extension of the trade-through rule to all NMS stocks. Specifically, Citadel does not believe there is

[3] Securities Exchange Act Release No. 49325 (Feb. 26, 2005), 69 Fed. Reg. 11126, 11128 (Mar. 9, 2004).
[4] "Highway to Hybrid," Security Industry News (May 3, 1003)(asserting that "by the end of the year, virtually all U.S. equity and options exchange will be electronic or hybrid to respond to competition and regulatory reforms").

any discernable public policy justification for any application of the trade-through rule to electronic markets. In the marketplace for Nasdaq stocks, where there is not a trade-through rule and quotes are generally immediately and electronically accessible, market quality is superior and trade-throughs are not an issue. Market participants have no incentive to ignore a better priced quote that provides certainty through instant execution.

While Citadel is opposed to any trade-through rule, the SEC's proposal is significantly better than the status quo and would eliminate the fundamental flaw of having to wait for responses from manual markets for listed stocks. The SEC has correctly recognized the "serious weakness" in the current trade-through rule – its failure to reflect the "disparate speed of response between manual and automated quotations." [5] The proposed intermarket sweep exemption addresses most of Citadel's concerns about the SEC's initial trade-through proposal and would ensure the efficient execution of large orders.

Citadel's main critique of the SEC's proposal is that the definition of an automated trading center does not make explicit that an automated trading center must protect "away markets" that are also automated.[6] Specifically, an automated trading center should be required to immediately and automatically route orders to other automated trading centers to protect the away markets' quotes and limit orders or to step up to match the better away markets' prices (unless an existing intermarket sweep order already protects away markets). The SEC appears to have contemplated such a requirement in the proposal. Citadel would like to see this requirement spelled out more explicitly.

Citadel strongly supports the rule's extension to the listed options markets. The fundamental philosophical and market structure issues are the same in the equities and options markets. Like the listed equities markets, the quality and effectiveness of the options markets is impaired by a trade-through rule that lacks an exception for manual quotes. Indeed, the problems caused by applying the trade-through rule to manual quotes

[5] Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424, 77427 (Dec. 27, 2004) ("Reproposal").

[6] An "away market" is a different market from the market in which an order was originally placed., and comes into play when insufficient shares are available to fill an order. For example, if an order for 30,000 shares is placed on the NYSE, but only 29,000 shares are available, the remaining 1000 shares are routed to an "away market."

are more pronounced in the options markets. Options are derivative in nature and thus must rapidly react to price changes in the underlying securities. Moreover, there are no exceptions to the options market trade-through rule like there are in the equities markets.

(2) The Top-of-Book and Depth-of-Book Alternatives (In Relation to Market Sweep Exemption)

Citadel would support a top-of-book trade-through rule, provided the final rule contains the four key components previously mentioned: (1) an ability to bypass manual markets, (2) an intermarket sweep exemption, (3) a clear definition of automated markets, and (4) its extension to the options markets.

The intermarket sweep exemption as defined by the SEC is crucial to the success of any trade-through rule and should be adopted without modification. The SEC defines an intermarket sweep order as "a limit order that meets the following requirements: (1) the limit order is identified as an intermarket sweep order when routed to a trading center, and (2) simultaneously with the routing of the limit order, one or more additional limit orders are routed to execute against all better-priced protected quotations displayed by other trading centers up to their displayed size."

Citadel believes the SEC's proposed market sweep exception will be beneficial to all investors. Market efficiency would be improved by avoiding unnecessary message traffic and indefinite message loops. Immediate execution would be facilitated where there is no risk of a trade-through. Market participants would be enabled under the exemption to simultaneously and immediately sweep through multiple price levels in multiple markets.

Citadel believes that a depth-of-book rule would be difficult and costly for many market participants to implement, and might complicate surveillance and compliance with the rule. In addition, the great complexity involved in implementing a depth-of-book solution would no doubt create unintended consequences that we can not now foresee.

(3) Consequences If Any of These Proposals Are Adopted

For the reasons described above, Citadel believes the markets, and therefore all investors, would be better served by abolition of the trade-through rule rather than by incremental reforms such as those proposed by the SEC. Nevertheless, Citadel believes that the SEC's proposal, if adopted, would be an improvement over the model we have now.[7] Under the SEC's proposal, market participants would be free to route orders to manual markets; however, market participants would no longer be required to do so in the listed equity markets, as the current trade-through rule provides. Citadel agrees that "investors are best served when the markets are free to compete and offer an array of execution options."[8] Accordingly, the SEC's proposed modified trade-through system would help achieve the goal of free markets reflected by this important principle. In particular, Citadel commends the exclusion of manual quotations from protection in the SEC's proposed revisions to the trade-through rule. Tangible benefits in the listed equity markets likely to result from the proposed rule include: an increase in market transparency and liquidity; a decrease in effective spreads and execution costs; and a dramatic improvement in execution speed and certainty.

(4) The SEC's Empirical Justifications for the Proposal.

The SEC has correctly recognized the "serious weakness" in the current trade-through rule – its failure to reflect the "disparate speed of response between manual and automated quotations." As the SEC stated, "[b]y requiring order routers to wait for a response in the manual market, the ITS trade-through provisions can cause an order to miss both the best price of a manual quotation and slightly inferior prices at automated markets that would have been immediately accessible."[9] The proposed revised trade-

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[7] Securities Exchange Act Release No. 34-50870 (Dec. 16, 2004) "Regulation NMS would include new substantive rules that are designed to modernize and strengthen the design of the US equities markets. First, the 'Trade-Through Rule' would require trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception.").

[8] John A. Thain, CEO, New York Stock Exchange, Testimony Before Senate Banking Committee – Proposed Regulation NMS (July 21, 2004).

[9] *Id.*

through rule, by excluding manual quotations, would reduce the impact of this fundamental flaw in the current national market system and thus substantially improve the system.

A number of commenters have pointed out flaws in the SEC's analysis in regard to the question of whether to extend the trade-through rule to the Nasdaq market. In particular, these commenters believe that the SEC's analysis overstated the actual number of trade-throughs in Nasdaq stocks, drew the wrong conclusion from the data regarding a supposed lack of liquidity in Nasdaq stocks, and failed to adequately capture the overwhelming superiority in execution quality of Nasdaq stocks. Based on our own experience trading large volumes of both Nasdaq and listed equity securities, we believe strongly that the execution quality of the Nasdaq marketplace is significantly better than that of the listed marketplace.

Conclusion

For the reasons stated, the SEC should abolish the existing trade-through rule altogether or immediately implement the changes to the trade-through rule proposed in Regulation NMS. Either result will promote transparency, competition, highest quality prices, and speed of execution, and ensure that U.S. markets remain the strongest and most efficient markets in the world. Thank you.

Exhibit 1

CITADEL

January 22, 2005

4-496

VIA FEDERAL EXPRESS

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Petition for Rulemaking to Amend the Options Intermarket Linkage Plan

Dear Mr. Katz:

Citadel Investment Group, L.L.C. ("Citadel")[1] petitions the Securities and Exchange Commission (the "Commission") to address systemic market weaknesses caused by the trade-through provisions of the Options Intermarket Linkage Plan.[2] Specifically, the Commission should limit Linkage Plan trade-through protection only to automated quotes.[3] Eliminating anti-competitive requirements that prevent market participants from consistently obtaining reliable, automated order handling in the options markets will enhance price discovery, create more liquid and deep markets, and significantly benefit all market participants.

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[1] Citadel and its affiliates have over 900 employees, with headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. Citadel's affiliate Citadel Derivatives Group LLC is registered with the Commission as a broker-dealer and is a member of the International Securities Exchange, the Chicago Board Options Exchange, the Philadelphia Stock Exchange, the American Stock Exchange, the Pacific Exchange, and the Boston Options Exchange. On average, Citadel's affiliates account for between one and two percent of the daily dollar volume traded on both the New York and Tokyo Stock Exchanges, and more than 10% of daily U.S. listed equity options contract volume.

[2] Joint Industry Plan: Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Securities Exchange Act Release No. 43086 (July 28, 2000), 65 Fed. Reg. 48023 (Aug. 4, 2000) (the "Linkage Plan" or "Plan").

[3] Specifically, pursuant to Rule 192 of the SEC Rules of Practice, 17 CFR 201.192, Citadel petitions the Commission to institute a rulemaking proceeding to amend the Plan's trade-through rule to synchronize it with the trade-through rule set forth in proposed Regulation NMS. See Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424 (Dec. 27, 2004) ("Reproposal"). The Commission has the authority to amend the Plan under Section 11A(a)(3)(B) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 11Aa3-2 thereunder. Correspondingly, Citadel petitions the Commission to order the American Stock Exchange ("AMEX"), the Boston Stock Exchange ("BOX"), the Chicago Board Options Exchange ("CBOE"), the International Securities Exchange ("ISE"), the Pacific Exchange ("PCX"), and the Philadelphia Stock Exchange ("PHLX") and any other future Plan participants (collectively, "Plan Participants") to amend their respective rules to conform to these Plan amendments. The Commission has authority to issue an order requiring the SROs to conform their rules to the proposed Plan amendments under Section 19(c) of the Exchange Act. Alternatively, the Commission could extend Regulation NMS to the options markets.

I. Executive Summary

The existing trade-through rule governing the listed equity markets fails to recognize the distinction between manual and automated quotations. The Commission and market participants have concluded this failure to distinguish between types of quotes substantially impairs the quality and effectiveness of the national market system for equities. As a result, the Commission has proposed Regulation NMS, which seeks to address the inherent limitations of the current trade-through rule as it relates to manual equity markets.

The arguments in favor of revising and updating the trade-through rule in the options markets are even more compelling than in the equities markets. Although the trade-through rule causes similar problems in both markets, the effects are amplified in the options markets. First, because options are derivatives, there is a greater need for automated order handling in the options markets to enable rapid reaction to price movements in underlying equities. Second, the absence of "upstairs" trading of listed options prevents brokers from insulating their customers from the delays and uncertainty of manual order handling. Citadel thus urges the Commission to recognize this regulatory gap in the options markets and to address the issue with all due speed.

Specifically, the Commission should limit trade-through protection in the options markets to automated quotations, leaving manual quotations unprotected. The Commission should do so by revising the trade-through provisions of the Options Linkage Plan in a manner consistent with proposed Regulation NMS, and order the Plan Participants to revise their rules accordingly.[4]

In addition to this long-term solution, the Commission should implement interim measures to immediately improve the operation of the options markets. First, the Commission should prohibit the options exchanges from discriminating against broker-dealer orders (including away market maker orders) with respect to access to the exchanges' automatic execution systems and should afford broker-dealer orders the same firm quote protection as customer orders. Second, the Commission should adopt a uniform obvious error rule that is objective, fair, and prevents exchange discrimination against orders routed from other exchanges. Third, the Commission should allow any firm that routes a linkage order to bring an arbitration claim against the receiving exchange for the exchange's failure to handle the order as required by

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[4] Citadel continues to believe that the market structure issues related to the trade-through rule would be best addressed—in both the equities markets and the options markets—through the elimination of the existing trade-through rules altogether. Nevertheless, as we explained in Citadel's original comment letter regarding proposed Regulation NMS, and as Citadel will reiterate in our comment letter on the reproposal of Regulation NMS (which will be submitted to the Commission shortly), an appropriately crafted trade-through rule that limits trade-through protection to automated markets' automated quotes, would be a major improvement over current market structure. See Letter from Kenneth Griffin, President and CEO, Citadel, to Jonathan G. Katz, Secretary, Commission (July 9, 2004) ("2004 Comment Letter").

the Options Linkage Plan. Among other important benefits, these interim measures would almost entirely eliminate locked and crossed markets.

II. Trade-Through Rule Reform is Essential for the Option Markets

The Commission, Citadel, and many other market participants agree that the current application of trade-through protection to both automated and manual quotations impedes the efficient operation of the national market system.[5] The delays inherent in manual markets, through slow order handling, phantom quotes, or otherwise, impede consistent receipt of quality execution or any execution at all. Yet, the existing trade-through rules in both the equities and options markets effectively require market participants to attempt to access manual quotes, without recognizing the harm caused by this mandated uncertainty.

To address this issue in the equities markets, the Commission proposed Regulation NMS, which would revise the equities trade-through rule to permit market participants to trade through manual quotations.[6] Citadel strongly endorses this approach and recognizes the substantial and immediate benefits this would bring to the equities markets. The options markets need such a change even more. Therefore, the Commission should quickly modernize the options trade-through rule in a similar manner.

A. The Need for Trade-Through Reform is Even More Compelling in the Options Markets

The trade-through rule affects the options markets more profoundly than the equities markets for a number of reasons. First and foremost, execution time lags are even more likely to harm investors trading listed options. Because options are derivatively priced, it is critical that investors have the capability to react nearly instantaneously to price movements in the underlying securities. For example, due to the slowness and unreliability of manual market executions, options market makers are less willing to provide liquidity because they must factor in options execution time lags when considering how much liquidity to provide and at what price level. In addition, delayed or uncertain executions negatively impact hedging and arbitrage strategies involving listed options and the underlying equities or other related instruments. The effectiveness of hedging and arbitrage strategies is degraded the longer it takes to execute one leg of the hedge or arbitrage. As the Commission previously has recognized, these strategies contribute to the depth and liquidity of *both* the equity and options markets and facilitate efficient price discovery.

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5 See Original NMS Proposal at 11133-11134 and n.45 (noting that this point has been raised in various forums, including congressional hearings, trade publications and conversations with regulators); Section 1 of 2004 Comment Letter.

6 See Proposed Rule 611 of the Reproposal.

Second, on manual exchanges, compliance with the basic requirements of the Options Linkage Plan has been lax and enforcement of those requirements has been inconsistent, at best. The AMEX and its market makers and specialists consistently fail to provide the requisite firm quotes and to execute or respond to orders within required time periods, even after facing a Commission enforcement action concerning similar issues. In fact, AMEX conduct and conduct on the AMEX has undermined the options markets to such an extent that Citadel filed with the Commission a Petition for Sanctions Against the American Stock Exchange ("Petition for Sanctions") to ensure that the Commission was more fully informed about the nature and extent of the AMEX's misconduct.[7]

Third, unlike the listed equities markets, the options markets have no safety valve, such as "upstairs" trading, to address the problems caused by the current trade-through rule. In listed equities markets, broker-dealers use upstairs trading extensively to insulate customers from manual market execution delays and uncertainty, by providing customers with immediate "upstairs" execution. For example, as a result of upstairs trading, retail brokerage customers can immediately buy or sell many National Market System stocks at the National Best Bid or Offer ("NBBO"), in amounts even greater than is quoted at the NBBO. In listed options markets, however, a broker-dealer is prohibited from filling a customer order in this manner. As a result, customers bear the full brunt of listed option execution delays, uncertainty, and unfilled orders.[8]

B. The Options Markets Are Technologically Capable of the Proposed Reforms

The options markets have matured significantly in recent years. The tremendous success of the all-electronic ISE, the launch of the all-electronic BOX, and the roll-out of hybrid trading on the CBOE and PCX belie any notion that the options markets are not ready for an increased level of automation and a corresponding regulatory structure.[9] Moreover, if our proposed

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[7] A copy of the Petition for Sanctions, including the First Supplement to the Petition for Sanctions Against the American Stock Exchange filed Jan. 21, 2005 ("First Supplement"), is attached as Appendix B.

[8] Listed option contracts may be traded only on a national securities exchange that is an Options Clearing Corporation ("OCC") participant. See Article VI, Section 1 of the OCC By-Laws.

[9] Citadel strongly supports the development of innovative new trading technologies and increased automation of the handling of orders on the floor-based exchanges. However, the benefits of such an expansion in automated execution capabilities will be significantly undermined if Plan Participants can disengage their automated execution systems or operate these systems in any manner other than the normal manner set forth in the Plan Participant's rules. The Commission should continue to be vigilant in monitoring and enforcing the floor-based exchanges' compliance with the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, see Securities Exchange Act Release No. 43268 (Sept. 11, 2000), Administrative Proceeding File No. 310282, and the rules that the exchanges adopted to satisfy those requirements, see AMEX Rule 933(f), PCX Rule 6.87(h) and Phlx Rule 1080(c) and (e).

reforms are adopted, any markets that conclude that they are not up to the challenge of modernization would be free to preserve their existing framework. As under Regulation NMS, markets would not be required to automate. Manual markets would, however, have to decide whether to automate, knowing that the trade-through rule would no longer prohibit market participants from avoiding interaction with manual markets.

C. These Reforms Would Further Inter-Market Consistency

The time has come for trade-through rule modernization in the listed options markets. The public policy and philosophical questions are fundamentally the same as those considered in the Commission's Regulation NMS deliberations. Applying a similar trade-through rule framework to the options and equities markets would continue the recent trend toward, and the Commission's strong desire for, regulatory consistency across markets.

In recent years, the Commission has attempted to update options market structure in a manner similar to that of the equities markets. For example, the options markets now have an intermarket linkage, a firm quote rule, a consolidated NBBO, and the inclusion of size in displayed quotes.[10] In a similar vein, the SEC recently cited equality of regulation across markets as a primary reason for its adoption of Regulation SHO[11] and its proposal of Regulation NMS.[12]

III. Improving the Trade-Through Provisions of the Options Linkage Plan

To address the market structure deficiencies described above, the Commission should repeal the existing trade-through provisions of the Options Linkage Plan and replace them with a trade-through rule similar to proposed Rule 611 of Regulation NMS. We recommend that these proposed Plan amendments take the form set forth in Appendix A.

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10 When the Commission adopted these regulations for the equities markets, it did not apply the initiatives to the options markets because the trading of standardized options was relatively new and needed time and opportunity to develop. See, e.g., Securities Exchange Act Release No. 43086 (July 28, 2000), 65 Fed. Reg. 48023 (Aug. 4, 2000).

11 Securities Exchange Act Release No. 48709 (Oct. 29, 2003), 68 Fed. Reg. 62972 (Nov. 6, 2003); Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004). The uniform bid test is on hold until the end of the Pilot Program. See Securities Exchange Act Release No. 50104 (July 28, 2004), 69 Fed. Reg. 48032 (Aug. 6, 2004).

12 Original NMS Proposal at 11128-29.

A. Overview

Citadel's proposed trade-through rule would take a substantially different approach than the trade-through provisions currently contained in the Options Linkage Plan.[13] Because the Plan's trade-through provisions were drafted at a time when most listed options trading took place on floor-based exchanges, the existing provisions fail to distinguish between manual and automated quotations and their disparate speeds and reliability of response. In addition, rather than prohibiting trade-throughs, the current provisions only state that Participants "should avoid" trade-throughs and provide an after-the-fact complaint procedure for aggrieved markets. Our proposed trade-through rule would address both of these structural deficiencies.

1. Protect Only Automated Quotations

First and foremost, our proposed trade-through rule would only protect automated quotations. An automated quotation would be defined as one that, among other things, is displayed and immediately accessible through automatic execution. Thus, our proposed trade-through rule would not require Participants attempt to access any manual quotations, which generally entail a slow and uncertain response.

More specifically, our proposed trade-through rule would protect only "protected bids or protected offers" (subject to the exceptions discussed in Section B). Protected bids and offers would consist of the best automated quotations, displayed by an automated Participant.

An automated quotation would be defined as a quotation displayed by a Participant that: (1) permits an incoming order to be marked as immediate-or-cancel; (2) immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size; (3) immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere; (4) immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and (5) immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms. Consequently, a quotation would not qualify as automated if there is any human intervention on the part of the receiving market or an opportunity for intentional delay in response.

An automated Participant would be defined as a Participant that (1) has implemented such systems and rules as are necessary to render it capable of displaying automated quotations; (2) identifies as manual quotations all quotations that are not automated quotations; (3) immediately identifies its quotations as manual quotations whenever it has reason to believe that

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13 See Section 8(c) of the Options Linkage Plan.

it is not capable of displaying automated quotations; (4) immediately and automatically routes orders to other automated Participants to protect better automated quotations displayed by other automated Participants, or steps up to match the better automated quotations displayed by other automated Participants;[14] and (5) has adopted reasonable standards limiting changes in the automated or manual status of its quotations, including specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets.

2. Make the Rule Easier to Enforce

In addition, Citadel's proposed trade-through rule would incorporate an approach to trade-throughs that is stricter and more comprehensive than the current Plan provisions. First, our proposal would require Participants to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, or, if relying on one of the proposed rule's exceptions, that are reasonably designed to assure compliance with the exception. To assure compliance, such policies and procedures would need to incorporate objective standards that are coded into a Participant's automated systems. Moreover, a Participant would be required to regularly surveil to ascertain the effectiveness of its policies and procedures and to take prompt action to remedy deficiencies. In this way, our proposed trade-through rule would eliminate the inadequate and loose standard for enforcement currently applied through the Plan.

B. Exceptions to Trade-Through Liability

Any trade-through rule must be implemented in a manner that is efficient and workable. To achieve this goal, Citadel's proposed trade-through rule would include certain exceptions that are intended to address potential practical difficulties, including flickering quotes and system malfunctions.[15] These exceptions generally would limit the application of Citadel's proposed trade-through rule to quotations that are truly accessible.

1. Flickering Quotations

The first of these exceptions involves flickering quotations. A Participant's best displayed quotation often can change multiple times in a single second. These rapid price changes can create the impression that a quotation was traded through, when in fact the trade was

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[14] This automated routing or step up requirement is an addition to the language of proposed Regulation NMS. As will be discussed in greater detail in Citadel's forthcoming comment letter about Regulation NMS, Citadel believes that this requirement is an important additional characteristic of automated markets.

[15] See Proposed Sections 8(c)(iii) of the Options Linkage Plan. In addition, the proposed trade-through rule would provide exceptions for openings and reopenings and crossed markets.

effected nearly simultaneously with the display of the quotation. To address this problem of flickering quotations, the Commission should allow a one-second "window" prior to a transaction for Participants to evaluate the quotations at another Participant.[16] Participants would be entitled to trade at any price equal to or better than the least aggressive best bid or best offer, as applicable, displayed by the other Participant during that one-second window.

2. Self-Help Exception

In addition, Citadel's proposed trade-through rule would provide an exception for the quotations of Participants experiencing a material delay in providing a response to incoming orders due to a failure, material delay, or systems or equipment malfunction.[17] This exception addresses concerns that Participants should not be dependent on the willingness and capacity of other markets and market makers to meet, and the Commission's and markets' ability to enforce, these automation requirements. Our proposed trade-through rule, therefore, would provide a "self-help" remedy that would allow Participants to bypass the quotations of a Participant that fails to meet the immediate response requirement. This would address some of the significant problems with the current trade-through rule, as discussed above.

IV. Stopgap Measures

Despite the tremendous recent growth and improvements in the options markets, these markets are reaching only a fraction of their potential. One of the principal constraints preventing the options markets from reaching their true potential is the Options Linkage Plan's trade-through rule. Citadel recognizes, however, that even with the Commission's most diligent efforts to move quickly, options market trade-through rule modernization will take time to adopt and implement. Therefore, the Commission should implement the following incremental steps, which could be quickly achieved and would provide immediate and necessary improvements.

A. Prohibit Discrimination Among Orders

Options market makers are prevented from providing greater liquidity to the extent that manual markets and manual market makers intentionally delay handling market maker orders or decline to honor posted quotes. For example, certain exchanges continue to place restrictions on access to their automatic execution ("auto-ex") systems for broker-dealer orders, especially market maker orders. Moreover, current rules offer very limited firm quote protection to broker-dealer orders. By manually handling market maker orders, and failing to honor quotes, floor-based market makers have the ability unilaterally to expropriate free options from electronic market makers—that is, an option to execute orders based on market movements that occur

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16 See Proposed Section 8(c)(iii)(F) of the Options Linkage Plan.

17 See Proposed Section 8(c)(iii)(A) of the Options Linkage Plan.

while a floor-based market maker sits on an order. The Commission should quickly address this issue by prohibiting options exchanges from discriminating with respect to their auto-ex systems and by affording broker-dealer orders the same firm quote protection as customer orders. These basic steps would go a long way towards eliminating the chronic problem of locked and crossed markets created by the existing framework as a result of phantom quotes and execution delays.

1. Equal Access to Auto-Ex Systems

Citadel urges the Commission to amend the options exchanges' rules regarding access to their auto-ex systems to the extent that those rules discriminate between customer orders and broker-dealer orders. Despite recent strides in this area, certain exchanges still restrict their auto-ex functionality for orders for the accounts of broker-dealers generally or for the accounts of market makers in particular.[18] Depending on the exchange and the options class, broker-dealer orders may be guaranteed an execution for fewer contracts than customer orders,[19] may not be able to interact automatically with limit orders on the limit order book,[20] or may not be eligible for automatic step-up or price improvement features.[21] There policies may result in more orders being "kicked out" to the floor for manual handling. Market maker orders may be subject to additional limitations, such as speed bumps prohibiting the entry of multiple orders with a particular time period (*e.g.*, 15 seconds).[22] There is no reason why these disparities should continue to exist.

By way of background, several years ago, the options exchanges made changes to their auto-ex systems to allow for automatic execution of larger numbers of contracts for customer trades.[23] The exchanges made these changes in response to an evolving options market structure,

18 Historically, these rules have stated that broker-dealer orders are not eligible for automatic execution, unless the exchange's floor procedure committee or similar body determines on a class-by-class basis to allow such orders to be executed automatically. See e.g., AMEX Rule 933; CBOE Rule 6.8.

19 See, e.g., AMEX Rule 933-ANTE (c)(1).

20 See, e.g., CBOE Rule 6.8 Interpretation .01(b)(1) (for those classes on RAES that have not been designated by the appropriate floor procedure committee as eligible to participate in a pilot program allowing broker-dealer orders to automatically execute against the book).

21 See, e.g., AMEX Rule 933- ANTE (c)(2).

22 See, e.g., CBOE Rule 6.13(b)(i)(c)(iii)

23 See Exchange Act Release No. 49175 (Feb. 3, 2004), 69 Fed. Reg. 6124-01 (Feb. 9, 2004). For example, when CBOE began allowing automated executions of up to 500 contracts in QQQ options, AMEX immediately matched its proposal and the ISE soon announced that it would guarantee a size up to 2,000 contracts in the two near-term expiration months, and up to 1,000 for all other expirations. Amex soon matched ISE's advance; and Phlx and PCX followed suit shortly thereafter.

CITADEL

advances in technology, and increased competition among the markets. Around the same time, the exchanges began to allow broker-dealer orders (other than market maker orders) to be executed through their auto-ex systems, albeit in a limited fashion.[24] These changes were met with approval by the Commission. Specifically, the Commission noted that increased access to auto-ex systems would "improve the efficiency with which orders for the accounts of broker-dealers are executed" and "by providing prompt execution for broker-dealer orders, [which] also may help attract broker-dealer options orders to the Exchange, and thus help improve the depth and liquidity of the Exchange's options market."[25]

It has been four years since the exchanges began permitting broker-dealer orders to be executed through their auto-ex systems, subject to a number of significant limitations. The options markets are now sufficiently mature and technologically advanced to allow all broker-dealers—including away market makers, whether they are routing orders through the linkage or directly to another exchange—to have equal access to the exchanges' auto-ex systems. Therefore, it is now time to remove the remaining impediments to such unfettered access. This change would have immediate practical benefits, ranging from a reduction of locked and crossed markets to the creation of a more precise order handling audit trail.

2. Equal Protection Under the Firm Quote Rule

Citadel also petitions the Commission to amend the provisions of the Commission's firm quote rule governing transactions in listed options.[26] In particular, the Commission should amend Rule 11Ac1-1(d) under the Exchange Act to require that size be displayed with all disseminated listed options quotes and that displayed quotes be firm for all orders. Although the rule requires that listed options quotes be firm for customer orders, the rule does not require that quotes be firm for broker-dealer orders for more than one contract.[27] This makes it impossible for a broker-dealer (including an away market maker) to determine whether a quote is firm or

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[24] See Securities Exchange Act Release No. 46598 (Oct. 3, 2002), 67 Fed. Reg. 63478 (Oct. 10, 2002); Securities Exchange Act Release No. 45758 (April 15, 2002), 67 Fed. Reg. 19610 (April 22, 2002); Securities Exchange Act Release No. 46479 (Sept. 10, 2002), 67 Fed. Reg. 58654 (Sept. 17, 2002); Securities Exchange Act Release No. 45032 (Nov. 6, 2001), 66 Fed. Reg. 57145 (Nov. 14, 2001).

[25] Securities Exchange Act Release No. 46479 (Sept. 10, 2002), 67 Fed. Reg. 58654 (Sept. 17, 2002). In approving a similar PCX proposal, the Commission found that the use of auto-ex systems by broker-dealers was consistent with the Exchange Act in that it was designed to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest." See Exchange Act Release No. 45032 (Nov. 6, 2001), 66 Fed. Reg. 57145 (Nov. 14, 2001).

[26] Exchange Act Rule 11Ac1-1(d), 17 CFR 240.11Ac1-1(d).

[27] Id. The Linkage Plan further requires that quotes be firm for up to 10 contracts with respect to broker-dealer linkage orders.

ephemeral, or to obtain reliable executions, because the displayed size may not be firm for its orders. This harms the market as a whole by diminishing transparency and liquidity.

Firm quotes have provided tremendous benefits to investors in both the equities and options markets. The existence of a uniform quote requirement in the equities markets has lead to tighter spreads, aggressive price discovery, and true market transparency. Uniform firm quotes have also been extremely well received on the ISE and are one of the primary reasons recognized by observers for the ISE's resounding success. One of the most common arguments against requiring firm quotes in options markets for all market participants has historically been that "professional traders" will put market makers out of business if market makers are required to execute professional orders at quoted prices. The ISE's experience proves, however, that a universally applied firm quote rule can be successfully applied to the options markets.

B. Adopt a Uniform Obvious Error Rule

Today, not only do options market participants have to endure and attempt to access manual market phantom quotes, they have to endure phantom executions. Options orders frequently are busted by certain manual exchanges hours after execution (and sometimes even the next trading day) based on vague or non-existent standards, and the decisions to bust are made by people with an incentive to favor the "home team." These delayed busts are particularly harmful because they often retroactively expose market participants to the full market risks represented by their suddenly and unexpectedly naked hedges. This type of manual market misconduct is discussed in greater detail in the Petition for Sanctions.[28]

To remedy this type of misconduct, promote market integrity, and ensure a consistent approach across the exchanges, the Commission should adopt a uniform options obvious error rule that is objective, fair, and prevents discrimination against orders routed from other exchanges. Citadel proposes an "obvious error" standard for busts, similar to the standard successfully employed by certain exchanges.[29]

Under Citadel's proposal, Plan Participants would be permitted to bust a transaction or adjust the execution price of a transaction *only* if it is a result of an "obvious error." An "obvious error" would be deemed to have occurred *only* when the execution price of a transaction meets a

[28] See pp. 12-17 and Exhibits D, G, H, I, J, K, L of the Petition for Sanctions and Section I of the First Supplement.

[29] See ISE Rule 720; BOX Rules Ch. 5, Sec. 20, PCX Rule 6.87(g); Phlx Rule 1092. Correspondingly, Citadel petitions the Commission to revoke any existing exchange rule that is inconsistent with this objective standard.

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pre-determined objective price standard.[30] A determination of whether an "obvious error" has occurred would have to be made pursuant to specific procedures and time limits set forth in the rule. Under our proposal, if a market maker believes that it has participated in a transaction that was the result of an obvious error, it must notify the Exchange's market control center or similar body within five (5) minutes of execution. If an order entry firm believes that it has experienced an obvious error, it must report to market control within twenty (20) minutes of the execution. Market control would not grant relief unless notification is made within the prescribed time period. If market control determines that a transaction was the result of an "obvious error," the trade would be adjusted to the next best bid or offer at the time of the trade, unless the *both* parties agree otherwise. The parties may request a review of market control's decision by an obvious error panel, which *must* render a decision on the same day as the transaction, or the next day if the request is made after 3:30 p.m. Eastern Time.[31]

C. Allow Arbitration Claims for Exchange Mishandling of Linkage Orders

As detailed in Citadel's Petition for Sanctions, failures to comply with the Options Linkage Plan are common occurrences. Options market makers who route linkage orders (which is often effectively *required* by the current trade-through rule) have little recourse for such violations. Currently, the Plan provides no method for settling disputes that arise between Plan Participants and market participants who use the linkage. This failure to provide a forum for market participants to air grievances *in a neutral forum* and hold Plan Participants accountable is especially troubling because the Commission affords Plan Participants tremendous power and leeway in implementing and enforcing the Plan. As a result, market participants currently are limited to contacting the Commission about violations and asking the Commission to consider addressing violations through rulemaking or an enforcement action against the relevant Plan Participant. Such an approach, even if it is eventually successful, does not remedy any issues with regard to particular trades.

To address these inequities, the Commission should allow any firm that routes a linkage order to bring an arbitration claim against the receiving exchange for failing to handle the order as required by the Linkage Plan. Such an approach would not only address the particular wrong,

[30] The execution price must be higher or lower than a pre-determined Theoretical Price for the series by a specified amount. For example, under ISE Rule 720, if the Theoretical Price for a series is below $2.00, and the execution price is at least $.25 higher or lower than $2.00, an obvious error is deemed to have occurred. Similarly, if the Theoretical Price for a series is $20.00, and the execution price is at least $1.00 higher or lower than $20.00, an obvious error is deemed to have occurred.

[31] All determinations made by the Exchange, market control or the obvious error panel shall be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration. See e.g., ISE Rule 720.04. See also, section IV(C) below regarding arbitration of Option Linkage Plan disputes.

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but would help to encourage the Plan Participants' compliance with the Options Linkage Plan on an ongoing basis.

V. Conclusion

The Commission has broad authority to address the serious problems facing the options markets as a result of an obsolete Options Intermarket Linkage Plan. The Commission has decided to address similar problems in the equities markets. It is now time to bring parity to the two markets by applying these same solutions to the options markets. Citadel urges the Commission to take swift action to remedy these problems by amending the Options Linkage Plan to permit trade-throughs of manual quotes and to order Plan Participants to amend their rules accordingly. A failure to address these serious issues will have significant negative ramifications for investors and our national market system.

* * * * *

We appreciate the opportunity the Commission provides to participate in the critically important debate regarding options market structure. If we can answer any questions or provide further insights, Citadel would be delighted to discuss these issues further.

Sincerely,

Adam Cooper/jcn

Adam Cooper/jcn
Senior Managing Director and
General Counsel

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth K. King, Associate Director, Division of Market Regulation

Enclosures

4-496

Appendix A

Deletions are [bracketed], and additions are **underlined and in bold**.

* * * * *

Plan for the Purpose of Creating and Operating an Intermarket Option Linkage

* * * * *

Section 2 - Definitions

1) - No change.

2) "Automated Quotation" means a quotation displayed by a Participant that:

(a) Permits an incoming order to be marked as immediate-or-cancel;

(b) Immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size;

(c) Immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere;

(d) Immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and

(e) Immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.

3) "Automated Participant" means a Participant that:

(a) Has implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the requirements for an Automated Quotations set forth in paragraph 2 of this Section.

(b) Identifies all quotations other than Automated Quotations as Manual Quotations.

(c) Immediately identifies its quotations as Manual Quotations whenever it has reason to believe that it is not capable of displaying Automated Quotations

(d) Has adopted reasonable standards limiting when its quotations change from Automated Quotations to Manual Quotations, and vice versa, to specifically defined circumstances that promote fair and efficient access to its Automated Quotations and are consistent with the maintenance of fair and orderly markets; and

(e) Immediately and automatically routes orders to other Automated Participants to protect better Automated Quotations displayed by the other Automated Participants; or steps up to match the better Automated Quotations displayed by other Automated Participants.

[2) - 13)] - 4) - 15) - No change

[14) - 17)] - 16) - 19) - No change.

20) "Manual Quotation" means any quotation other than an Automated Quotation.

[18) - 25)] - 21) - 28) - No change.

29) "Protected Bid or Protected Offer" means a quotation in an options series of an Eligible Option Class that:

(a) Is displayed by an Automated Participant;

(b) Is disseminated pursuant to an effective national market system plan ; and

(c) Is an Automated Quotation that is the best bid or best offer of a Participant.

30) "Protected Quotation" means a Protected Bid or Offer.

[26) - 28)] - 31) - 33) - No change

[29)] 34) "Trade-Through" means a transaction in an options series of an Eligible Option Class during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer [at a price inferior to the NBBO].

[30)] - 35) - No change.

* * * * *

Section 8 - Participants' Implementation Obligations

(a) - (b) - No change

(c) Order Protection

The Participants agree that[, absent reasonable justification and during normal market hours,] members in their markets should not effect Trade-Throughs. Accordingly, the Participants agree to approve and submit to the SEC for its consideration uniform rules governing Trade-Throughs that contain the following provisions:

(i) [Trade-Throughs.]

[(A)] General Provision. **A Participant shall establish, maintain and enforce written policies and procedures that are reasonably designed to prevent Trade-Throughs of Protected Quotations in any options series of an Eligible Option Class that do not fall within an exception set forth in paragraph (iii) below and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.** [When purchasing or selling, either as principal or agent, any options series of an Eligible Option Class, or when sending a Linkage Order, members of a Participant should avoid initiating a Trade-Through unless one or more of the provisions of paragraph (iii) are applicable.]

(ii) [(B)] Surveillance. **A Participant shall regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (i) above and shall take prompt action to remedy deficiencies in such policies and procedures.**[Each Participant shall establish procedures to conduct surveillance of their markets to identify trades executed at prices inferior to the NBBO and shall maintain records identifying Trade-Throughs and the actions taken by such Participant in response to Trade-Throughs.]

[(C) Disciplinary Action. The uniform rules shall provide that it will be a violation of a Participant's rules for a member to engage in a pattern or practice of trading through bids and offers that are entitled to be satisfied pursuant to paragraph (ii)(B) below (whether or not Satisfaction Orders with respect to such Trade-Throughs are received from members of other Participants whose bids or offers were traded through ("aggrieved parties") unless one or more of the provisions of paragraph (iii) below are applicable, provided however, that a Block Trade executed at a price inferior to the NBBO shall not be considered a Trade-Through for the purpose of this paragraph if the member initiating the trade satisfied all aggrieved parties pursuant to paragraph (ii)(B) below following the execution of the Block Trade.]

(iii) Exceptions.

(A) The transaction that constituted the Trade-Through was effected when the Participant displaying the Protected Quotation that was traded-through was experiencing a failure, material delay, or malfunction of its systems or equipment when the Trade-Through occurred.

(B) The transaction that constituted the Trade-Through was a single-priced, opening, reopening, or closing transaction by the Participant.

(C) The transaction that constituted the Trade-Through was executed at a time when a Protected Bid was priced higher than a Protected Offer in that options series.

(E) The Participant displaying the Protected Quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the Trade-Through, a best bid or best offer, as applicable, for the option series with a price that was equal or inferior to the price of the Trade-Through transaction.

(ii) Satisfaction of Trade-Throughs - deleted.

(iii) Exceptions to Trade-Through Liability - deleted

(iv) Responsibilities and Rights Following Receipt of Satisfaction Orders - deleted

Matthew F. Andresen

Mr. Andresen is the President of Citadel Execution Services and the Co-Head of Citadel Derivatives Group, an affiliate of Citadel Investment Group, L.L.C.

Prior to joining Citadel, Mr. Andresen served as Head of Global Trading for Sanford C. Bernstein. In that role, he was responsible for all aspects of Bernstein's $300M trading business.

Prior to Bernstein, Mr. Andresen served for five years as President and CEO of Island ECN and then COO of Instinet. As one of the first three employees of Island, he built this electronic stock market into the largest in the country. He was responsible for all strategic and operational decisions at Island.

Mr. Andresen also recently served on the Board of Directors of Lava Trading, a New York trading technology company. Lava is the leading provider of front-end trading systems to the Equity Trading industry.

Mr. Andresen graduated in 1993 from Duke University in Durham, NC with a B.A. in Economics and Political Science.

A former world-class fencer, Mr. Andresen was a National Champion, a four-time All-America, a member of dozens of U.S. National Teams, and an alternate for the 1996 US Olympic team.

TESTIMONY OF KIM BANG,

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BLOOMBERG TRADEBOOK LLC,

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES,

U.S. HOUSE OF REPRESENTATIVES,

REGARDING

"THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?"

FEBRUARY 15, 2005

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. MY NAME IS KIM BANG, AND I AM PLEASED TO TESTIFY ON BEHALF OF BLOOMBERG TRADEBOOK REGARDING "THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?".

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BLOOMBERG TRADEBOOK IS A GLOBAL ELECTRONIC AGENCY BROKER SERVING INSTITUTIONS AND OTHER BROKER-DEALERS. WE COUNT AMONG OUR CLIENTS MANY OF THE NATION'S LARGEST INSTITUTIONAL INVESTORS REPRESENTING — THROUGH PENSION FUNDS, MUTUAL FUNDS AND OTHER VEHICLES — THE SAVINGS OF MILLIONS OF ORDINARY AMERICANS.

BLOOMBERG TRADEBOOK SPECIALIZES IN CONSOLIDATING WHAT HAS BEEN A FRAGMENTED MARKET BY INCREASING TRANSPARENCY AND ACCESS TO LIQUIDITY ACROSS COMPETING MARKET CENTERS.

I. THE UNDERLYING ISSUE DRIVING REG NMS IS THE NEAR MONOPOLY THE NYSE ENJOYS OVER THE TRADING VOLUME IN ITS LISTED SECURITIES

THE HOUSE FINANCIAL SERVICES COMMITTEE HAS LONG UNDERSTOOD HOW SEEMINGLY ABSTRACT MARKET STRUCTURE ISSUES HAVE A DIRECT BEARING ON THE EFFICIENCY AND COMPETITIVENESS OF OUR MARKETS AND THE INTERESTS OF INVESTORS. THE COMMITTEE'S INTEREST IN THE SEC'S REGULATION NMS PROPOSAL IS WELCOME AND WARRANTED.

PROPOSED REGULATION NMS IS AN AMBITIOUS EFFORT TO ENGAGE POLICY MAKERS, MARKET PARTICIPANTS AND THE PUBLIC IN A DEBATE OVER HOW BEST TO PROMOTE THE LONG-OVERDUE MODERNIZATION OF THE U.S. EQUITY MARKETS.

MARKET PARTICIPANTS AND POLICY MAKERS HAVE OFTEN ASKED "WHY DOES THE NYSE CONTROL 80 PERCENT OF THE TRADING VOLUME OF ITS LISTED COMPANIES WHEN NASDAQ CONTROLS ONLY ABOUT 20 PERCENT OF THE VOLUME OF ITS LISTED COMPANIES?" THE ANSWER IS SIMPLE — REGULATORY BARRIERS TO COMPETITION. IF THE BARRIERS ARE REMOVED AND INVESTORS AND FIDUCIARIES THEN FREELY CHOOSE TO SEND THEIR ORDERS TO THE NYSE, THAT WOULD BE THE RESULT OF FREE COMPETITION AND INVESTOR CHOICE, FACTORS NOT CURRENTLY PRESENT.

II. THE OTC MARKET AS A MODEL FOR A COMPETITIVE MARKET

THE NASDAQ MARKET SINCE 1996 PRESENTS THE OPPOSITE PICTURE — IT IS A MARKET INTO WHICH REGULATION INTRODUCED AND ENCOURAGED COMPETITION. THE NASDAQ PRICE-FIXING SCANDAL OF THE MID-1990S RESULTED IN THE SEC'S 1996 ISSUANCE OF THE ORDER-HANDLING RULES. THOSE RULES ENHANCED TRANSPARENCY AND COMPETITION IN THE NASDAQ MARKET AND PERMITTED ELECTRONIC COMMUNICATIONS NETWORKS — ECNS — TO LEVEL THE PLAYING FIELD BETWEEN INVESTORS AND INTERMEDIARIES BY

GRANTING INVESTORS DIRECT MARKET ACCESS TO THE NATIONAL MARKET SYSTEM.

INDEED, THE INCREASED TRANSPARENCY PROMOTED BY THE SEC'S ORDER-HANDLING RULES AND THE SUBSEQUENT INTEGRATION OF ECNS INTO THE NATIONAL QUOTATION MONTAGE NARROWED NASDAQ SPREADS BY NEARLY 30% IN THE FIRST YEAR FOLLOWING ADOPTION OF THE ORDER-HANDLING RULES. THESE, AND SUBSEQUENT REDUCTIONS IN TRANSACTIONAL COSTS, CONSTITUTE SIGNIFICANT SAVINGS THAT ARE NOW AVAILABLE FOR INVESTMENT THAT FUELS BUSINESS EXPANSION AND JOB CREATION.

THE QUESTION CONFRONTING THE SEC AND THE CONGRESS IS WHETHER OUR MARKETS IN LISTED SECURITIES CAN BE REFORMED TO BRING THE SAME BENEFITS TO THE NYSE INVESTOR AS THEY HAVE TO THE NASDAQ INVESTOR. NOW THAT THE NYSE HAS BEEN FORCED TO GIVE UP ITS RULE 390 (RESTRICTING ORDER FLOW TO THE OTC MARKET) AND RULE 500 (RESTRICTING THE ABILITY OF LISTED COMPANIES TO DELIST), THE EXISTING TRADE-THROUGH RULE REMAINS THE FOREMOST IMPEDIMENT TO COMPETITION AND MARKET EFFICIENCY.

III. THE TRADE-THROUGH RULE HAS HISTORICALLY FUNCTIONED AS PROTECTIONIST REGULATION

THE TWENTY-YEAR-OLD TRADE-THROUGH PROVISION OF THE INTER-MARKET TRADING SYSTEM PLAN STATES THAT WHEN THE SPECIALIST OR MARKET MAKER RECEIVES AN ORDER, IT CANNOT EXECUTE IT AT A PRICE INFERIOR TO ANY FOUND ON ANOTHER MARKET WITHOUT GIVING A "FILL" TO THE BETTER-PRICED ORDER. BUT THERE IS A GAP BETWEEN THE RULE'S PRINCIPLE AND ITS PRACTICE. UNDER THE RULE, ORDERS ARE NOT PROTECTED SO MUCH AS THEY ARE UNFAIRLY EXPLOITED.

CONSIDER, FOR EXAMPLE, THE AMERICAN STOCK EXCHANGE. BLOOMBERG TRADEBOOK CLIENTS GENERALLY AVOID THE AMEX. THEY DO SO BECAUSE AMEX QUOTATIONS ARE INDICATIVE ONLY — NOT FIRM — AND TAKE 10 TO 15 SECONDS TO BE FILLED OR REJECTED. IN TODAY'S ELECTRONIC MARKETS, IN WHICH MARKETS MOVE IN MILLISECONDS, A DELAY OF 10 TO 15 SECONDS IS AN ETERNITY.

INVESTORS, FIDUCIARIES AND MARKET PARTICIPANTS FACE THE SAME PROBLEM WITH THE NYSE WHEN THE SPECIALIST DISPLAYS AN INDICATIVE PRICE, WHICH IS NOT A BINDING ONE. A MARKET PARTICIPANT SENDING TO THE NYSE MANUAL MARKET A MARKETABLE LIMIT ORDER (THAT IS, AN ORDER AT A PRICE EQUAL OR BETTER THAN THE ADVERTISED QUOTATION) OFTEN FINDS THAT THE ORDER IS HELD UP

AND NOT EXECUTED FOR AN AVERAGE OF MORE THAN 20 SECONDS WHILE THE SPECIALIST GOES THROUGH THE AUCTION PROCESS. DURING THAT PROCESS, THE ORDER MAY BE REJECTED, OR FILLED AT A PRICE INFERIOR TO THE ADVERTISED PRICE.

WHILE THIS AUCTION PROCESS IS GOING ON, THE SPECIALIST HAS A FREE OPTION. UNTIL HE COMMUNICATES AN EXECUTION OR REJECTION, THE ORDER ENTRANT CANNOT EFFECTIVELY DRAW THE ORDER BACK OR MODIFY IT. INVESTORS, IN EFFECT, GRANT A FREE OPTION TO THE SPECIALIST WITH EVERY MANUAL ORDER. THAT'S HOW THE SPECIALISTS PROSPER, PARTICULARLY GIVEN THE MONOPOLIES THEY ENJOY. INVESTORS THEREBY INCUR AN OPPORTUNITY COST AND THE SPECIALIST GAINS THE ADVANTAGE. IN THE MEANTIME, THE MARKET OFTEN MOVES.

THE CLEAR DISADVANTAGE TO INVESTORS IS NOT ONLY IN HAVING THEIR ORDERS HELD UP ON AMEX OR THE NYSE, BUT ALSO IN BEING DEPRIVED OF PRICING OPPORTUNITIES REPRESENTED IN OTHER MARKETS. WHAT IS NEEDED IS GIVE TO INVESTORS THE CHOICE OF MARKET VENUE, WITH OR WITHOUT BROKER INTERMEDIATION. INVESTOR CHOICE IS THE CORNERSTONE OF FREE AND COMPETITIVE MARKETS.

IV. **THE CURRENT TRADE-THROUGH RULE DOES NOT PROTECT INVESTORS**

WE SHARE WITH SINCERE PROPONENTS OF TRADE-THROUGH RULES A VISION OF A NATIONAL MARKET SYSTEM THAT PROMOTES TRANSPARENCY AND ACCESS TO LIQUIDITY AND LEVELS THE PLAYING FIELD BETWEEN INVESTORS AND INTERMEDIARIES. WERE A TRADE-THROUGH RULE EFFECTIVE AND NECESSARY TO ACHIEVE THESE ENDS, WE WOULD SUPPORT IT WITHOUT RESERVATION.

THE REALITY, HOWEVER, IS THAT THE EXISTING TRADE-THROUGH RULE DOES NOT PROVIDE ANY MEANINGFUL INVESTOR PROTECTION. IT IS, INSTEAD, AN IMPEDIMENT TO ACHIEVING BEST EXECUTION. IT HAS STOOD IN THE WAY OF INNOVATION AND COMPETITION.

V. **SHOULD THE TRADE-THROUGH RULE BE MADE A FEDERAL LAW EXTENDED TO ALL STOCKS?**

MUCH OF THE IMPETUS FOR MARKET REFORM HAS BEEN DRIVEN BY THE INDUSTRY-WIDE CONSENSUS THAT THE NYSE NEEDED TO MODERNIZE — A CONSENSUS GIVEN INCREASED IMPETUS BY LAST YEAR'S SPECIALIST SCANDALS IN WHICH SEVEN SPECIALIST FIRMS AGREED TO PAY ALMOST $250 MILLION TO SETTLE AN SEC PROBE INTO ALLEDGED TRADING ABUSES. WE DON'T BELIEVE THAT EXTENDING THE

TRADE-THROUGH RULE TO THE OTC MARKET IS THE BEST WAY TO ACHIEVE MEANINGFUL CHANGE IN THE NYSE. JUST BECAUSE THE NYSE IS IN NEED OF SOME STERN MEDICINE DOESN'T MEAN OTHERS HAVE TO TAKE IT AS WELL.

WE WOULD RESPECTFULLY SUBMIT THAT THE GOALS OF THE NATIONAL MARKET SYSTEM CAN BE MOST FULLY AND EFFECTIVELY REALIZED WITH GREATER TRANSPARENCY AND UNINTERMEDIATED ACCESS TO FIRM QUOTATIONS. GREATER MANDATORY DISPLAY OF LIQUIDITY BEYOND THE NATIONAL BEST BID AND OFFER ("NBBO") AND IMMEDIATE ELECTRONIC ACCESS WOULD MAKE FOR A BETTER, MORE COMPETITIVE NATIONAL MARKET SYSTEM. MARKET PARTICIPANTS HAVE IMPLEMENTED EXECUTION-MANAGEMENT SYSTEMS, INTER-MARKET CONNECTIVITY AND SMART ORDER-ROUTING SYSTEMS THAT ENABLE THEM TO SEEK BEST EXECUTION FOR THEIR CLIENTS.

WE THINK THOSE TECHNOLOGIES PROVIDE THE BASIS FOR A MORE EFFICIENT AND COMPETITIVE MARKET. WE BELIEVE THAT IN PART BECAUSE FIDUCIARIES COULD NOT — AND WE BELIEVE WOULD NOT — IGNORE WITH IMPUNITY INFORMATION RIGHT IN FRONT OF THEM ABOUT HOW TO ROUTE THEIR ORDERS TO THE BEST PRICES. ECONOMIC SELF-INTEREST, COUPLED WITH COMPETITION TO MAXIMIZE PORTFOLIO PERFORMANCE, WOULD DO MORE THAN HEAVY-HANDED

GOVERNMENTAL REGULATION AIMED AT DICTATING ORDER-ROUTING PRIORITIES.

VI. THE STUDY PUBLISHED BY THE COMMISSION IN SUPPORT OF A TRADE-THROUGH RULE IS SERIOUSLY FLAWED[1]

THE ARGUMENTS FOR A TRADE-THROUGH RULE IN THE OVER-THE-COUNTER MARKET IN NASDAQ SECURITIES ARE WEAKER STILL. THE SEC'S OFFICE OF ECONOMIC ANALYSIS (OEA) TRADE THROUGH STUDY SEEKS TO COMPARE TRADE THROUGHS IN NASDAQ SECURITIES WITH TRADE THROUGHS IN EXCHANGE-LISTED SECURITIES. WHILE THE OEA IS TO BE COMMENDED FOR ITS EFFORTS, WE BELIEVE IT MAY HAVE SIGNIFICANTLY OVERESTIMATED THE INCIDENCE OF TRADE THROUGHS IN THE OTC MARKET. THAT OVERESTIMATION MAY HAVE ARISEN BOTH BECAUSE OF METHODOLOGICAL SHORTCOMINGS IN THE STUDY — PARTICULARLY ITS FAILURE TO CONSIDER "RESERVE" AND "REPLENISHMENT" FUNCTIONS AND ITS OVERSTATEMENT OF INVESTOR IMPACT — AND BECAUSE OF CHANGES IN THE OTC MARKET SINCE THE STUDY WAS COMPLETED.

RESERVE. THE MOST PROMINENT OF THE METHODOLOGICAL SHORTCOMINGS IS THE FAILURE TO ACCOUNT FOR HOW THE ECN'S RESERVE AND REPLENISHMENT FEATURES MAY INACCURATELY HAVE

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1 *See,* "Analysis of Trade-throughs in Nasdaq and NYSE Issues," Memorandum to File from SEC Office of Economic Analysis (December 15, 2004) (the "OEA Trade Through Study").

BEEN PERCEIVED AS TRADE THROUGHS. THE OEA TRADE-THROUGH STUDY DID NOT CONSIDER THE IMPACT OF RESERVE AND REPLENISHMENT. AS A RESULT, THE TRADES COUNTED AS TRADE THROUGHS WERE IN MANY CASES FALSE POSITIVES. THAT DISTORTED THE DATA AND THE STUDY'S CONCLUSIONS. THESE DISTORTIONS OCCURRED BECAUSE THE STUDY USED A THREE-SECOND "WINDOW" FOLLOWING A TRADE AS THE MEASUREMENT OF WHETHER A TRADE-THROUGH OCCURRED. THAT WINDOW IGNORED THE EFFECT ON MANY ECNS OF RESERVE, IN WHICH UNDISPLAYED QUANTITIES LIE BELOW THE DISPLAYED QUANTITIES AND, WHEN A DISPLAYED QUANTITY IS EXHAUSTED, PART OR ALL OF THE RESERVE POPS UP IN ITS PLACE WITHIN A FRACTION OF A SECOND. THE THREE-SECOND WINDOW USED BY THE OEA TREATED THE POP UP AS IF IT WERE THERE ALL ALONG, MISCHARACTERIZING IT AS HAVING BEEN TRADED THROUGH.

INADVERTENT OVERSTATEMENT OF INVESTOR IMPACT. THE OEA STUDY HAS ANOTHER FLAW. IN MEASURING THE IMPACT OF TRADE-THROUGHS, IT RELIES IN PART ON A CLEARLY ERRONEOUS METHOD OF COUNTING THE VOLUME OF A TRADE-THROUGH. FOR EXAMPLE, WHERE A TRANSACTION TRADES THROUGH A 500-SHARE ORDER, THE TRADE THROUGH SHOULD BE COUNTED AS 500 SHARES, NOT THE POSSIBLY MUCH GREATER SIZE OF THE TRANSACTION THAT TRADED THROUGH 500 SHARES — IT COULD HAVE BEEN 5,000 SHARES, 50,000 SHARES OR WHATEVER. THE STUDY USES BOTH APPROACHES IN

MEASURING TRADE THROUGHS. BY ONE MEASURE, USING THE CORRECT APPROACH, THE TRADE THROUGH INCIDENCE WAS STATED TO BE 1.7% OF NASDAQ SHARE VOLUME (WHICH WAS ITSELF OVERSTATED GIVEN THE OTHER CALCULATION PROBLEMS SUCH AS THE EFFECT OF RESERVE AND REPLENISHMENT). USING THE OTHER METHOD, THE TRADE-THROUGH INCIDENCE WAS OVERSTATED TO BE 7.9% OF NASDAQ SHARE VOLUME. THIS LATTER NUMBER BEARS NO RELATION TO THE FACTS ON THE GROUND. EVEN IF 1.7% WERE AN ACCURATE READING, THAT NUMBER HARDLY WOULD JUSTIFY THE ECONOMIC DISLOCATION AND REDUCTION IN INVESTOR CHOICE THAT WOULD BE NEEDED TO ADDRESS THIS RELATIVELY SMALL PROBLEM.

OTC DEVELOPMENTS. IN THE YEAR SINCE THE OEA TRADE THROUGH STUDY WAS UNDERTAKEN AND CONCLUDED, NASDAQ PURCHASED BRUT ECN IN 2004, PROVIDING NASDAQ WITH SMART ORDER-ROUTING CAPABILITIES. ONCE THE INTEGRATION OF THE TWO SYSTEMS IS COMPLETE, TRADE THROUGHS ON THE NASDAQ MARKET SHOULD BE REDUCED, WITHOUT THE IMPOSITION OF ADDITIONAL REGULATION.

DURING THE STUDY DATES, THE ARCHIPELAGO EXCHANGE ("ARCAEX") PLATFORM OPERATED AN EXTERNAL ORDER ROUTER THAT PERMITTED ORDERS IN THE ARCAEX PLATFORM TO REACH BETTER-PRICED LIQUIDITY OUTSIDE OF ARCA. EXTERNALIZING ORDERS MATERIALLY DECREASES THE OCCURRENCE OF TRADE THROUGHS, AS

EVIDENCED IN THE OEA TRADE-THROUGH STUDY. THOSE FINDINGS SUPPORT THE CONCLUSION THAT MARKETS USING SMART ORDER-ROUTING TECHNOLOGY CAN EFFECTIVELY REDUCE AND LIMIT TRADE THROUGHS FOR BOTH LARGE AND SMALL TRADES.

AS A RESULT OF THESE FLAWS, THE OEA TRADE-THROUGH STUDY IS AN INADEQUATE BASIS FOR REGULATORY ACTION. THE STUDY HAS BEEN INTRODUCED INTO THE TRADE-THROUGH DISCUSSION IN SUPPORT OF EXTENDING A TRADE-THROUGH RULE TO THE OTC MARKET. THE STUDY DOES NOT, HOWEVER, SUPPORT THE CONCLUSION THAT A TRADE-THROUGH RULE IS NECESSARY OR APPROPRIATE FOR THE OTC MARKET.

VII. THE SEC'S TWO TRADE-THROUGH PROPOSALS

WE DO NOT SUPPORT EITHER OF THE TRADE-THROUGH PROPOSALS BECAUSE WE THINK A TRADE-THROUGH RULE IS BOTH UNNECESSARY AND BURDENSOME.

AS BETWEEN THE TOP-OF-BOOK ALTERNATIVE AND THE DEPTH-OF-BOOK ALTERNATIVE, WE THINK THE PHILOSOPHY OF A TRADE-THROUGH RULE IS MORE SUPPORTIVE OF THE LATTER BECAUSE THE UNIVERSE OF PROTECTED ORDERS WOULD BE EXPANDED TO INCLUDE NOT JUST THOSE AT THE TOP PENNY ON THE BID OR BOTTOM PENNY ON THE OFFER BUT ALL DISPLAYED ORDERS. THE LIMITED TOP-OF-BOOK ALTERNATIVE INVITES "PENNYING" AND PROVIDES VERY LITTLE NEW OR

MEANINGFUL PROTECTION IN A DECIMAL WORLD, WHILE LEAVING THE NYSE FREEDOM TO DISADVANTAGE INVESTORS AND FIDUCIARIES AND TO SHUT OUT ITS COMPETITORS.

THE DEPTH-OF-BOOK PROPOSAL DOES NOT HAVE THOSE DEFECTS, BUT WE THINK IT WOULD BE MORE THAN IS NEEDED TO ACCOMPLISH THE COMMISSION'S OBJECTIVE — AND WOULD BE LIKELY TO STIFLE INNOVATION AND COMPETITION.

VIII. THERE IS AN ALTERNATIVE TO A TRADE-THROUGH RULE

DECIMALIZATION HAS BEEN A BOON TO INVESTORS AND AN ENORMOUS SPUR TO MARKET EFFICIENCY. THIS COMMITTEE PLAYED A CRITICAL ROLE IN PRODUCING THIS MARKET REVOLUTION. HOWEVER, THE RULES GOVERNING THE DISPLAY OF MARKET DATA — RULES CRAFTED IN AN ERA OF EIGHTHS AND SIXTEENTHS — HAVE NEVER BEEN UPDATED TO REFLECT DECIMALIZATION.

SINCE DECIMALIZATION INTRODUCED 100 PRICE POINTS TO THE DOLLAR IN PLACE OF THE PREVIOUS EIGHT OR SIXTEEN, THE AMOUNT OF LIQUIDITY AVAILABLE AT THE NATIONAL BEST BID AND OFFER IS MUCH SMALLER THAN BEFORE. AS A RESULT, THERE HAS BEEN A DRAMATIC DIMINUTION IN TRANSPARENCY AND LIQUIDITY AT THE INSIDE QUOTATIONS.

THE SIA, IN COMMENTING ON REG NMS, ACCURATELY OBSERVED: "THE VALUE OF THE NBBO — THE CORNERSTONE OF THE MARKET DATA SYSTEM — IS LESS THAN IT WAS PRIOR TO DECIMALIZATION. WE BELIEVE THAT THE SEC HAS A RESPONSIBLILITY TO ADDRESS THIS ISSUE IN LIGHT OF THE OPERATION OF ITS QUOTE AND DISPLAY RULES (RULES 11Ac1-1 AND 11Ac1-4 UNDER THE EXCHANGE ACT)...."[2].

WE PUBLISH DATA ON EQUITY SECURITIES MARKETS THROUGHOUT THE WORLD. EVERY SIGNIFICANT MARKET OTHER THAN THE NYSE AND MEXICO CURRENTLY PUBLISHES REAL-TIME QUOTATIONS AT A MINIMUM OF FIVE LEVELS DEEP FOR ALL INVESTORS TO SEE AND IMMEDIATELY ACCESS ELECTRONICALLY. AS THE LARGEST EQUITY MARKET IN THE WORLD, THE NYSE SHOULD NOT CONTINUE TO DENY INVESTORS AND FIDUCIARIES THE SAME TRANSPARENCY AND ACCESS.

RATHER THAN INTRODUCE A NEW TRADE-THROUGH RULE, THE COMMISSION'S OBJECTIVES OF GREATER TRANSPARENCY AND ACCESS AND LIQUIDITY COULD BE BETTER ACHIEVED IF THE COMMISSION DID THE FOLLOWING:

- ELIMINATE THE EXISTING INTERMARKET TRADING SYSTEM TRADE-THROUGH RULE.

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2 Securities Industry Association, Comment letter on Regulation NMS (February 1, 2005) at p. 24, in SEC File No. S7-10-04.

- REVIEW AND IMPLEMENT, WITH APPROPRIATE MODIFICATIONS, THE NYSE'S OPEN BOOK AND HYBRID MARKET PROPOSALS.

- AMEND THE LIMIT ORDER DISPLAY RULE, EXCHANGE ACT RULE 11Ac1-4, TO REQUIRE EXCHANGES, MARKET MAKERS AND OTHER MARKET CENTERS (INCLUDING ECNS) TO PUBLISH ANY CUSTOMER LIMIT ORDERS RECEIVED OR COMMUNICATED TO OTHERS WITHIN FIVE CENTS OF THEIR BEST PUBLISHED QUOTATIONS (THAT IS TO SAY, FIVE CENTS ABOVE THE BEST OFFER AND FIVE CENTS BELOW THE BEST BID).

- REQUIRE ALL MARKET CENTERS TO HAVE THEIR PUBLISHED QUOTATIONS — NOT JUST THE TOP OF FILE — BE FIRM AND IMMEDIATELY "TOUCHABLE" ELECTRONICALLY BY MEMBERS OR PARTICIPANTS AND, THROUGH SYSTEMS SUCH AS THE NYSE'S DIRECT+, BY NONMEMBERS ELECTRONICALLY ENABLED BY MEMBERS.

- EXTEND TO DEPTH-OF-MARKET QUOTATIONS THE COMMISSION'S 30-CENT PER 100 SHARES CAP ON ACCESS FEES.

- AMEND THE VENDOR DISPLAY RULE, EXCHANGE ACT 11Ac1-2, TO REQUIRE VENDORS, SUCH AS BLOOMBERG L.P., TO CARRY ON THE SAME TERMS AS TOP-OF-FILE QUOTATIONS ALL DEPTH-OF-BOOK QUOTATIONS PUBLISHED BY ANY MARKET CENTER AS THAT TERM WOULD BE DEFINED IN RULE 600 OF PROPOSED REGULATION NMS, WITH THE POSSIBLE EXCEPTION OF MARKET CENTERS WHOSE SHARE OF VOLUME IS INSIGNIFICANT.

- ENFORCE MEANINGFUL COMPLIANCE WITH FIDUCIARY STANDARDS BY BROKERS AND INVESTMENT MANAGERS SO THAT THEY USE REASONABLE MEANS TO SEEK BEST EXECUTION OF CLIENT ORDERS, INCLUDING GETTING THE BEST ALL-IN PRICES. IF INVESTMENT MANAGERS AND BROKERS TODAY HAVE BEEN LAX IN LIVING UP TO THEIR DUTIES, THEY SHOULD BE REMINDED OF THEIR DUTY TO SEEK BEST EXECUTION OF ALL ORDERS. AUDITING OF THIS

DUTY — POSSIBLY COUPLED WITH ENHANCED DISCLOSURE SUCH AS THE COMMISSION IMPOSED ON MARKET CENTERS IN EXCHANGE ACT RULE 11Ac1-5 AND BROKERS IN RULE 11Ac1-6 — WOULD REDUCE INAPPROPRIATE TRADE THROUGHS AND MAKE A TRADE-THROUGH RULE UNNECESSARY.

WE THINK THE COURSE OF ACTION WE RECOMMEND WOULD PROMOTE A NUMBER OF BENEFICIAL EFFECTS. THERE WOULD BE A GREATER INCENTIVE THAN THERE IS TODAY TO PLACE LIMIT ORDERS. TODAY, FOR EXAMPLE, A MARKET PROFESSIONAL CAN OBSCURE A LARGE ORDER AT THE NBBO BY JUMPING AHEAD OF IT FOR A PENNY. AS A RESULT, THE ORIGINAL LIMIT ORDER IS NO LONGER VISIBLE OR ACCESSIBLE. (THE SAME PERVERSE INCENTIVE EXISTS UNDER THE "TOP OF FILE PROPOSAL.) IN EFFECT, INVESTORS ARE PENALIZED FOR QUOTING AGGRESSIVELY. WITH THE APPROACH WE RECOMMEND, PENNYING AN ORDER WOULD NOT BLOCK DISCLOSURE OF OR ACCESS TO THE ORIGINAL LIMIT ORDER.

THE COMBINATION OF MANDATORY TRANSPARENCY AND FAIR ACCESS TO QUOTATIONS BEYOND THE TOP OF FILE WOULD BENEFIT ALL INVESTORS, FIDUCIARIES AND OTHER MARKET PARTICIPANTS AND MAKE FOR A MORE TRANSPARENT AND LIQUID NATIONAL MARKET SYSTEM.

BROKERS AND INSTITUTIONAL INVESTORS WOULD HAVE TO BE ABLE TO REACH ALL SOURCES OF PUBLISHED LIQUIDITY TO MEET THEIR BEST-EXECUTION OBLIGATIONS. THE BEST-EXECUTION DUTY TODAY RESIDES WITH INVESTMENT MANAGERS AND BROKERS; THIS IS WHERE IT SHOULD BE, NOT WITH MARKET CENTERS. EXCHANGES AND MARKET CENTERS SHOULD NOT BE REQUIRED TO ESTABLISH ROUTING FACILITIES TO OTHER MARKETS. ALREADY EXISTING WIRE CONNECTIONS AND SMART ROUTERS SHOULD PROVIDE COST-EFFECTIVE MEANS OF DIRECTING ORDER FLOW TO THE MARKETS OFFERING THE DEEPEST LIQUIDITY AT THE BEST PRICES.

THIS IS A MODEST PROPOSAL. THE IMPACT OF THESE STEPS WOULD BE TO RESTORE THE TRANSPARENCY THAT HAS BEEN LOST AS AN UNINTENDED AND UNFORESEEN RESULT OF DECIMALIZATION. AS A POLICY MATTER IT IS HARD TO ARGUE THAT DECIMALIZATION SHOULD LEAVE THE PUBLIC WITH *LESS* TRANSPARENCY.

THE IMPACT OF SIMPLY UPDATING THE DISPLAY RULES, HOWEVER, COULD BE PROFOUNDLY POSITIVE IN ENCOURAGING THE DISPLAY OF DEPTH OF BOOK IN A FASHION THAT RELIES ON MARKET FORCES INSTEAD OF GOVERNMENTAL REGULATION. THIS IS FAR LESS INTRUSIVE THAN A TRADE-THROUGH RULE, WHICH WOULD BE EXPENSIVE TO IMPLEMENT AND DIFFICULT TO MONITOR AND ENFORCE.

ARMED WITH BETTER TRANSPARENCY AND ACCESS TO MARKET QUOTATIONS, BROKERS AND INVESTMENT MANAGERS WOULD HAVE POWERFUL INCENTIVES — PARTICULARLY GIVEN THEIR "BEST EXECUTION" DUTIES — TO REACH OUT FOR THE BEST PRICES AVAILABLE IN ANY MARKET, WHICH WOULD INCREASE INTER-MAKET COMPEITION AND LOWER TRANSACTION COSTS.

IX. THE MARKET BBO ALTERNATIVE AND THE NYSE HYBRID MARKET PROPOSAL

IF THE COMMISSION OPTS FOR THE MARKET BBO ALTERNATIVE, THERE ARE SIGNIFICANT RISKS REGARDING HOW THAT ALTERNATIVE WOULD INTERACT WITH THE NYSE HYBRID MARKET PROPOSAL. AS WE AND OTHER COMMENTERS HAVE PREVIOUSLY NOTED, SEVERAL ASPECTS OF THAT PROPOSAL ARE ILLOGICAL AND CUT AGAINST THE COMMISSION'S GOALS OF TRANSPARENCY AND FAIRNESS. MOST NOTABLY, THE "CLEAN UP" PRICE UNFAIRLY PENALIZES INCOMING MARKET AND MARKETABLE LIMIT ORDERS BY CHOOSING ARBITRARILY TO GIVE LIMIT ORDERS A BETTER DEAL THAN THEY HAD BARGAINED FOR IN SETTING THEIR LIMIT PRICES.

IF ALL ORDER GIVERS WERE BEING TREATED EQUALLY, THAT REGULATORY SUBSIDY FOR LIMIT ORDERS MIGHT BE DEFENSIBLE ON THE THEORY THAT INVESTORS SHOULD BE FAIRLY REWARDED FOR STEPPING UP AND GIVING THE MARKET WHAT IS IN ESSENCE A FREE OPTION.

NONETHELESS, THE NYSE HAS THUS FAR CHOSEN TO GIVE ITS FLOOR MEMBERS AN ADDITIONAL AND UNFAIR SUBSIDY IN THE FORM OF THE BROKER AGENCY INTEREST FILE AND THE SPECIALIST INTEREST FILE. THOSE NEW CONTRIVANCES WOULD GIVE FLOOR BROKERS A SPECIAL ADVANTAGE IN PLACING SECRET ORDERS INTO THE MARKET IN COMPETITION WITH DISCLOSED ORDERS. THAT, IN OUR VIEW, SUBSTANTIALLY DIMINISHES, IF INDEED IT DOES NOT VITIATE, WHATEVER POSITIVE ADVANTAGES MIGHT BE THOUGHT TO HAVE ARISEN FROM GIVING LIMIT ORDERS THE CLEAN-UP PRICE SUBSIDY.

THE BROADER ISSUE OF COURSE IS THE INTERACTION OF ALL THE PIECES OF THE MARKET STRUCTURE PUZZLE — REG NMS, OPEN BOOK, AND THE NYSE HYBRID PROPOSAL. AS REG NMS ENVISIONS MARKET PARTICIPANTS BEING REQUIRED TO GO TO THE NYSE, THERE IS A STRONG ARGUMENT THAT THESE OTHER NYSE PROPOSALS BE ADDRESSED FIRST, SO THAT MARKET PARTICIPANTS HAVE A CLEARER VISION OF HOW THE NYSE WILL FUNCTION. MOVING INITIALLY ON OPEN BOOK AND THE HYBRID WOULD ALSO ALLOW THE COMMISSION TO MEASURE THE IMPACT OF THESE INITIATIVES AND THEN DETERMINE WHETHER IMPLEMENTATION OF A FULL-DEPTH OF BOOK TRADE-THROUGH IS NECESSARY.

WE THINK THE NYSE IN FACT HAS MADE ENCOURAGING PROGRESS — UNDER THE CONSTANT AND EFFECTIVE PRODDING OF THE SEC. ITS OPEN BOOK PROPOSAL HAS SOME SHORTCOMINGS, BUT IF

IMPLEMENTED PROPERLY IT COULD RESTORE THE TRANSPARENCY THAT WAS LOST TO DECIMALIZATION. THE HYBRID MARKET PROPOSAL, IN ITS DIRECT+ ELEMENT, OFFERS ENHANCED ELECTRONIC ACCESS TO THE PUBLISHED QUOTATIONS. BOTH OF THOSE DEVELOPMENTS REPRESENT A WELCOME MODERNIZATION OF THE MARKET. WE THINK THE COMMISSION SHOULD PAUSE TO LET THEM BE PROPERLY IMPLEMENTED[3] BEFORE GIVING FURTHER CONSIDERATION TO WHETHER A TRADE-THROUGH RULE IS NECESSARY OR DESIRABLE.

WE EXPECT THAT, WITH INCREASED DISCLOSURE OF MARKET DATA, FIDUCIARIES AND INVESTMENT INTERMEDIARIES COULD NOT AND WOULD NOT IGNORE THOSE QUOTATIONS WHEN MAKING ORDER-ROUTING DECISIONS. ADHERENCE TO FIDUCIARY AND AGENCY DUTIES WOULD, WE BELIEVE, PROVIDE APPROPRIATE DISCIPLINE AND MAKE A TRADE-THROUGH RULE UNNECESSARY.

X. REG NMS AND MARKET DATA

THE CHAIRMAN OF THIS COMMITTEE HAS OFTEN OBSERVED THAT MARKET DATA IS THE "OXYGEN" OF THE MARKETS. ENSURING

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[3] The Commission appropriately blocked the NYSE's efforts to impose via contracts with market vendors improper limits on Liquidity Quote, which is substantially similar in operation to Open Book. These improper limits would have diminished the opportunity for competing market centers to offer comparable transparency. *Matter of Bloomberg*, Securities Exchange Act Release No. 49076 (January 14, 2004), avail. at: http://www.sec.gov/litigation/opinions/34-49076.htm. The NYSE has refiled its Liquidity Quote proposal with the Commission. There still are imperfections and shortcomings in that proposal, and in Open Book, and they are still under review at the Commission.

THAT MARKET DATA IS AVAILABLE IN A FASHION WHERE IT IS BOTH AFFORDABLE TO RETAIL INVESTORS AND WHERE MARKET PARTICIPANTS HAVE THE WIDEST POSSIBLE LATITUDE TO ADD VALUE TO THAT DATA ARE HIGH PRIORITIES.

IN ITS 1999 CONCEPT RELEASE ON MARKET DATA, THE COMMISSION NOTED THAT MARKET DATA SHOULD BE FOR THE BENEFIT OF THE INVESTING PUBLIC. INDEED, MARKET DATA ORIGINATES WITH SPECIALISTS, MARKET MAKERS, BROKER-DEALERS AND INVESTORS. THE EXCHANGES AND THE NASDAQ MARKETPLACE ARE NOT THE SOURCES OF MARKET DATA, BUT RATHER THE FACILITIES THROUGH WHICH MARKET DATA ARE COLLECTED AND DISSEMINATED. IN THAT 1999 RELEASE, THE SEC PROPOSED A COST-BASED LIMIT TO MARKET DATA REVENUES.

THAT COST-BASED APPROACH WOULD NOT REQUIRE THE NYSE AND NASDAQ TO SELL THE DATA AT COST. INSTEAD, IT WOULD REQUIRE THE CHARGES TO BE REASONABLY RELATED TO THE COST OF COLLECTING AND DISSEMINATING THE DATA. TODAY, THE SRO NETWORKS SPEND ABOUT $40 MILLION ON COLLECTION AND DISSEMINATION AND RECEIVE OVER TEN TIMES THAT MUCH — $424 MILLION — IN REVENUES.[4] THOSE REVENUES COME FROM INVESTORS.

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[4] *See*, Regulation NMS, Securities Exchange Act Release No. 50870 (December 16, 2004) in text accompanying n. 286:

FOR MONOPOLISTS SUCH AS THE NYSE AND NASDAQ TO CONTINUE TO RIDE ON THAT GRAVY TRAIN IS SIMPLY WRONG.

WE BELIEVE THE SEC WAS CLOSER TO THE MARK IN 1999 WHEN IT PROPOSED MAKING MARKET DATA REVENUES COST-BASED, THAN IN ITS REGULATION NMS PROPOSAL, WHICH SETS FORTH A NEW FORMULA FOR DISPENSING MARKET DATA REVENUE WITHOUT ADDRESSING THE UNDERLYING QUESTION OF HOW TO EFFECTIVELY REGULATE THIS MONOPOLY FUNCTION.

THE SEC WILL BE REVIEWING MARKET DATA FEES AS PART OF THE SRO STRUCTURE CONCEPT RELEASE. WE URGE THE SEC TO MOVE EXPEDITIOUSLY TO ADDRESS THIS IMPORTANT ISSUE, AND WE EMBRACE THE SIA'S CALL FOR A COST-BASED APPROACH TO MARKET DATA FEES. EVERY INVESTOR WHO BUYS AND SELLS STOCKS HAS A LEGITIMATE CLAIM TO THE OWNERSHIP OF THE DATA AND LIQUIDITY HE OR SHE PROVIDES TO MARKET CENTERS. FUNNELING EXCLUSIVE LIQUIDITY INFORMATION TO EXCHANGE MEMBERS AND FUNNELING MARKET DATA REVENUES TO EXCHANGES AND NASDAQ AND NOT TO INVESTORS SHIFTS THE REWARDS FROM THOSE WHO TRADE TO THOSE WHO FACILITATE TRADING. THE BENEFITS OUGHT TO BE CONFERRED UPON THE PUBLIC.

In 2003, the Networks collected $424 million in revenues derived from market data fees and, after deduction of Network expenses, distribute $386 million to their individual SRO participants. [footnote omitted].

XI. ACCESS FEES SHOULD BE ABOLISHED

ACCESS FEES — WHICH THE COMMISSION ALLOWED ECNS TO CHARGE WHEN IT ADOPTED THE ORDER EXECUTION RULES — ARE DYSFUNCTIONAL AND SHOULD BE ENTIRELY ABOLISHED. WE APPLAUD THE COMMISSION'S DECISION TO ABANDON THE CONVOLUTED APPROACH SUGGESTED WHEN REGULATION NMS WAS FIRST PROPOSED, BUT WE DO NOT THINK THE COMMISSION HAS GONE FAR ENOUGH. THE COMMISSION SHOULD NOT PRESERVE ACCESS FEES. THEY HAVE BEEN A CONTINUAL SOURCE OF MISCHIEF, SUCH AS REBATING PRACTICES, AND MARKET DISRUPTION, SUCH AS LOCKS AND CROSSES. IN ADDITION, THEY PROMOTE INTERNALIZATION OF ORDERS, WHICH REMOVES LIQUIDITY FROM THE NATIONAL MARKET SYSTEM. THERE IS NO GOOD ARGUMENT FOR KEEPING THESE FEES. THE COMMISSION'S DECISION TO RETAIN THEM IS, IN OUR VIEW, A SUBSTANTIAL MISTAKE.

CONCLUSION

THIS COMMITTEE HAS BEEN IN THE FOREFRONT OF THE MARKET STRUCTURE DEBATE AND I APPRECIATE THE OPPORTUNITY TO DISCUSS HOW THESE SEEMINGLY ABSTRACT ISSUES HAVE A CONCRETE REAL-WORLD IMPACT ON INVESTORS.

REGULATION NMS IS A BOLD STEP TO BRING OUR MARKETS INTO THE 21ST CENTURY. THE SEC IS TO BE COMMENDED FOR PROMPTING

WHAT HAS ALREADY BEEN A PRODUCTIVE DEBATE. IN AN EFFORT TO ACCOMMODATE A DIVERSE ARRAY OF INTERESTS, HOWEVER, WE BELIEVE THERE IS A RISK THAT REGULATION NMS MAY RE-SHUFFLE, RATHER THAN ELIMINATE, CURRENT IMPEDIMENTS TO MARKET EFFICIENCY.

ELIMINATION OF THE TRADE-THROUGH RULE, ELIMINATION OF ACCESS FEES, AND GREATER EFFORTS TO ENHANCE THE TRANSPARENCY AND CONTROL THE COSTS OF MARKET DATA WOULD HELP PROMOTE A 21ST CENTURY EQUITY MARKET THAT BEST SERVES INVESTORS.

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Testimony

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NYSE

Robert G. Britz
President & Co-Chief Operating Officer
New York Stock Exchange, Inc.

On

"The SEC's Market Structure Proposal: Will It Enhance Competition?"

Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
United States House of Representatives

Tuesday, February 15, 2005

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Tuesday, February 15, 2005

I. Introduction

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee. I am Robert Britz, President and Co-Chief Operating Office of the New York Stock Exchange Inc. (NYSE). I lead the Exchange's Equities Group, which is responsible for the day-to-day operation of our Trading Floor and our data processing sites, technical infrastructure, software development and information business. In addition, I serve as the Chairman of the Securities Industry Automation Corporation ("SIAC"), the NYSE's technology subsidiary.

On behalf of the NYSE, our Chairman John Reed and our Chief Executive Officer John Thain, thank you for providing me with the opportunity to testify this morning on securities market structure and the Securities and Exchange Commission's Regulation

NMS. We appreciate your initiative as we collaborate on how best to modernize our National Market System.

Today, over 2,760 companies are listed on the NYSE, with a market value in excess of $20 trillion. The NYSE has helped to both fuel the growth of U.S. enterprise and maintain the global pre-eminence of the U.S. capital markets. Our success has been won on the basis of our ability to provide the world's deepest pool of liquidity, the best price discovery, the highest certainty of order execution, the lowest overall cost of trading, and very importantly, the lowest volatility.

We applaud the SEC for its leadership in advancing a comprehensive proposal that serves as the basis for our discussions. We believe that the goal of Regulation NMS should be to protect investors by providing a framework to ensure their limit orders are protected and they receive the best price on their transactions, while at the same time ensuring they benefit from the forces of competition and innovation that have made our markets the envy of the world. This policy will not only provide the greatest benefits to investors, but is also the surest way to keep the United States in the forefront of global competition. The SEC has put on the table two alternatives, one of which achieves both these objectives, and the other of which would effectively transform our markets into a homogenized government utility.

I. The Market BBO Alternative

Throughout its deliberations of Regulation NMS, the Commission has properly emphasized the importance of protecting the best prices in each market center. This principle, which is embodied in the "trade-through rule," gives investors, both large and small, confidence that if they take the risk to be the best bid or offer, they will not be "traded through" – that is, ignored. This principle creates an incentive to gather at the best price, or improve it. The results are tighter spreads, greater liquidity, and equal treatment for all investors.

We are pleased that, since the last time we testified before your Subcommittee, investors have expressed substantial support for the establishment of a marketwide trade-through rule (applying to all markets, not just marketwide within one market).[1] The Investment Company Institute, for example, states in its comment letter that it "strongly supports the establishment of a uniform trade-through rule across all market centers and for all types of securities, including Nasdaq-listed securities.' They have stated that a marketwide trade-through rule represents a significant step in providing protection for limit orders, which would improve the price discovery process and contribute to increased market depth and liquidity. In addition, they point out, the rule would increase investor confidence in the securities markets by helping to eliminate an impression of unfairness when an investor's order executes at a price worse than the displayed quote.

[1] See, e.g., comment letters of The Investment Company Institute, (June 30, 2004, and January 26, 2005), T. Rowe Price Associates, Inc. (January 27, 2005), and the National Association of Investors Corporation (January 14, 2005), all of which represent the interests of investors.

Similarly, T. Rowe Price has taken the position that the fundamental rule should be that firms be rewarded for competing on price to attract order flow, which will enhance true market transparency and price discovery (noting that "[t]he Market BBO Alternative will also preserve and enhance intermarket competition. It will accommodate different trading models, allowing markets to continue to compete for order flow on the basis of the services they provide (e.g., negotiated floor auctions, speedy automated trade execution, ability to handle complex orders), the depth and liquidity of their markets and trading costs.")

In addition, many other market participants have expressed their support for the Commission's Market BBO Alternative, including Deutsche Bank, Bear Stearns, Barclays Global Investors, The Interactive Brokers Group, EWT, LLC (the Market BBO Alternative "[w]ill promote investor confidence in the fairness of the U.S. equity markets by protecting limit orders reflected in the BBO quotations displayed by the SROs against trade-through and protecting market and marketable limit orders against trading at prices inferior to those displayed best quotations. By protecting BBO quotations, the rule should encourage investors to use limit orders, leading to increased market depth, liquidity and efficiency."), the National Association of Investors Corporation, and others.

The Commission's "Market BBO Alternative" (sometimes also referred to as the "top of book" alternative) will benefit investors by establishing a marketwide trade-through rule that will ensure that investors' limit orders are protected and they receive the best price on their transactions, while at the same time giving them the benefit of

competition between the various markets trading stocks. It will also advance the following fundamental policy objectives:

- Promoting investors' ability to choose among alternative trading venues and order types;
- Lowering costs to investors and to issuers raising capital by accommodating market models that minimize price volatility; and

Importantly, the Market BBO Alternative strikes the appropriate balance between order competition and market competition. We agree with the Commission that relevant data supports the need for an intermarket rule to strengthen price protection and improve the quality of trading in both Nasdaq and exchange-listed stocks. By protecting the best bid and offer in each market, the Market BBO Alternative will encourage aggressive quoting within markets and assure the interaction of orders across markets, while at the same time permitting markets to compete on the basis of costs, liquidity and other elements of service and market quality. It will foster investor choice by avoiding the imposition of a single market model on investors. It will be practical to implement without undue costs. In turn, these benefits will minimize trading costs for investors, reducing the cost of capital for listed companies.

III. Mandatory Depth-of-Book Routing

By contrast, the Commission's "depth of book" routing alternative would destroy the congressionally mandated balance between order competition within markets and

competition between markets by completely eliminating the latter. This alternative would mandate that all markets route orders to any displayed limit order at a superior price in any market center. This approach would transform our market system into a virtual Consolidated Limit Order Book, or "CLOB." The CLOB has been proposed in the past, debated at length, and wisely rejected in 1978 and 2000 by previous SEC chairmen and commissioners for a number of reasons. Foremost among them is that it would convert our dynamic, diverse, and internationally competitive markets into a government-mandated, one-size-fits-all monolith.

At their extremes, order competition across markets and intermarket competition are mutually exclusive. Taken to the extreme, maximizing competition among orders at the expense of competition among markets would homogenize the markets and create a single, one-dimensional order-matching system. On the other hand, maximizing competition among markets at the expense of competition among orders would create complete fragmentation of the markets.

The Commission's depth of book routing alternative skews the balance toward order competition at too great a cost to intermarket competition. It would virtually eliminate intermarket competition and, paradoxically, diminish order competition at the same time. As Chairman Donaldson stated at SEC's hearings in April 2004, "Our markets are among the world's most competitive and efficient. Competition among markets has fostered technological innovation and the creation of trading platforms... that address the needs of all types of investors, regardless of size and sophistication."

Today, the preferences of investors and issuers, rather than regulation, determine which market models are successful. Investors in the U.S. markets benefit from spreads that are among the tightest and transaction costs that are among the lowest in the world. They also benefit from the freedom to choose the type of execution that is right for their orders. They choose strategies most appropriate for the size of their orders and the nature of the stocks traded. Whether they are retail investors purchasing 100 shares or an institution trading one million shares, they have options that enable them to receive the best prices from the trading venue of their choice. These benefits would be eliminated by the depth of book alternative.

A. The Depth of Book Alternative Will Virtually Eliminate Intermarket Competition

Markets compete in three important ways:

1. The prices at which orders can be executed (efficient price discovery);
2. The depth and liquidity they can attract (order aggregation) to promote optimal pricing and accommodate large orders; and
3. Execution fees.

Imposing depth of book routing on the markets will eliminate the first two bases for competition. The ability for markets to compete on the basis of depth and liquidity will erode if all displayed orders can participate in the pricing of every trade. This, in turn, will degrade the overall quality of prices that orders receive within each market, removing that consideration from the competitive equation as well. Instead, competition for limit orders would be based strictly on execution costs and, in all probability, will

push markets into a bidding war to purchase order flow or engage in fraudulent activities to reap market data rebates, fueling practices that harm our markets.[2] Limiting intermarket competition to a race to be the cheapest will also likely deprive markets of the resources they need to develop innovative new products and services, and to assure that their trading systems operate efficiently, securely and without disruption. As noted above, the end result is to homogenize the markets into a single, one-dimensional order-matching system.

B. The Depth of Book Alternative Will Diminish Order Competition

Mandatory DOB routing will diminish order competition by bifurcating the institutional and retail markets. Institutions and their brokers will find it increasingly difficult to execute large orders in the electronic virtual CLOB that mandatory depth of book routing would create. Money managers, institutional investors like pension funds and mutual funds, and other similar firms (otherwise known as the "buy side") also do not typically want the full size of their buying or selling interest publicly disclosed for fear that doing so will reveal important trading information to other market participants, ultimately raising their execution costs. Protecting their orders against trade-throughs through mandatory depth of book routing will do nothing to reduce this risk; indeed, it

[2] The NYSE continues to believe the Commission should ban payment for order flow, a practice fraught with conflicts of interest. Such payments interfere with the ability of retail orders to interact with each other and obtain the best execution price. In payment for order flow arrangements, individual investors rarely get the opportunity for an execution at the midpoint of the spread or better.

would exacerbate it because it would tend to force the display of latent interest as limit orders.

The result would be that large institutional orders would likely migrate to private markets or "upstairs" trading desks to be executed and reported often outside of market hours or in foreign venues. Mandatory depth of book routing would thus bifurcate the U.S. capital market into public retail markets operating within the NMS framework and private institutional markets operating outside the reach of the rule's responsibilities. The benefits that both types of orders enjoy when institutional and retail order flow interacts will be lost. Without large institutional investor participation in the NMS, spreads will widen, and execution quality for retail investors will deteriorate as liquidity evaporates in public markets.

C. The DOB Proposal Will Diminish Investor Choice

Investors and issuers benefit from different types of market models that compete with one another by providing different order types and services. The Commission's statistics cited in the reproposing release show that our floor-based auction combined with the current trade-through rule provides lower price volatility and far greater certainty of execution for larger size orders.[3] We believe this is due to the value that auction markets create by aggregating liquidity at a single point of sale. If auction markets must implement mandatory DOB routing, they would be forced to provide uniform execution

[3] The SEC's analysis reveals that, compared to NYSE-listed stocks, Nasdaq-listed stocks experience higher price volatility and a higher percentage of trade throughs. See 69 FR 77431-33.

facilities that disperse this liquidity by chasing quotes that will often disappear almost immediately after they are posted.

Recognizing the disparity between fill rates, as well as the opportunity to access reserve liquidity, buy-side firms and their brokers have developed so-called smart routers that analyze the quotations disseminated by various markets and route orders to them in accordance with a number of factors. One factor is the likelihood that an order routed to that market will in fact be executed. Mandatory DOB routing would force these firms to abandon their intelligent routing systems in favor of uninformed government-mandated routing, which will invariably lead to worse executions.

D. Depth of Book Routing Would Undermine Innovation Currently Underway at the NYSE

The NYSE's proposed hybrid market model cannot co-exist with mandatory DOB routing. We designed the hybrid market to have as many quotations as possible available for automated execution, while providing for the interaction of institutional and retail order flow, negotiated price discovery and the opportunity for the price improvement of a floor-based auction. The structural changes associated with the hybrid market model are widely supported by our customers, who want to have the choice of representing orders in both electronic and auction platforms. They support the hybrid market as an innovative and promising initiative. Regulation should promote innovation, not stifle it. Yet the Depth of Book alternative would prevent us from offering customers this choice.

IV. Market Data

The current model for the dissemination of securities market data has succeeded in making this data widely available, inexpensive and reliable. The Commission states in Regulation NMS that "investors of all types -- large and small -- have access to a comprehensive, accurate and reliable source of information for the price of any NMS stock at any time during the trading day."[4] Today, market data from all equity and options exchanges is highly reliable and widely used.

Regulation NMS is not the first SEC review of market data. There have been several important, thorough, industry-wide, SEC-mandated studies of market data in recent years, including the Commission's December 1999 SEC Concept Release: Regulation of Market Information Fees and Revenues (the "1999 Concept Release") and the SEC's Advisory Committee on Market Data in 2000-2001 ("the Seligman Committee").

The results of these reviews have essentially been the same: that market data is widespread, accurate, and the basis for and the amount of fees collected are fair and reasonable.

The primary dysfunction that emerges from these studies is that of the government-mandated consortium—the Consolidated Tape Association (CTA). Created

[4] 69 FR 77460.

in 1975 to ensure that investors had access to reliable, consolidated price information, CTA has outlived its usefulness.

The "Seligman Committee" experts concluded that dismantling the market data consortia was the best way to eliminate the distortions and abusive practices that the consortia breed. More generally, they recognized that allowing markets to withdraw from the consortia would eliminate the government allocation of data revenue, substituting the value proposition that each market's data presents as the allocator of revenue flows.

This harnessing of market forces to allocate data revenues would also relieve the markets from their joint administration problems and antitrust exposure; end artificial cooperation among competitors (thereby enhancing the forces of competition); remove incentives for tape shredding, wash sales and the use of exchanges as print facilities; starve payment for order flow, thereby reducing the classic conflicts with their customers that such payments create for brokers; and end inter-market subsidies, cross-network fee distortions and other market dislocations.

We have urged the Commission to embrace the recommendations of its own expert advisors by authorizing markets to withdraw from the market data consortia and thereby to permit and foster competing consolidators. Its consideration of the responses to its SRO concept release offers the next opportunity to do so. We have urged the Commission to seize it.

However, so long as the Commission continues to mandate a revenue-allocation formula, we support the Commission's proposal in Regulation NMS to use of quotes in the formula, the formula's use of square roots and dollar values (i.e., price X size), and the deletion of the NBBO Improvement Share. In the NYSE's January 26, 2005 comment letter to the Commission, we offered five suggestions to mitigate gaming and other distortions, and to facilitate the application of the formula.

We believe that our recommendations will make the proposed formula somewhat less susceptible to gaming, better align the value proposition of data with revenue allocation, and narrow the government's intervention in data display.

V. Conclusion

In conclusion, we appreciate this opportunity to appear before the Subcommittee and we look forward to working with you, Chairman Baker, Ranking Member Kanjorski, and the Members of the Subcommittee on market structure issues. Regulation NMS represents a significant, timely, and sensible reform of the national market system that will help to preserve the position of the U.S. as the leader in the global equities markets. It also represents the most far-reaching reform of the national market system since its creation 30 years ago.

We can best serve the public good by strengthening competition among markets to create a superior national market system that is based upon standards of best price and

putting the interests of investors first. These are the principles have made the U.S. securities markets the largest, most liquid and most vibrant in the world, and they can and must continue to do so in the 21^{st} Century.

Thank you again Chairman Baker for the opportunity to appear before the Subcommittee and I would be happy to answer any questions.

TESTIMONY
of
CARRIE E. DWYER
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL
THE CHARLES SCHWAB CORPORATION

before the

FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES

"THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?"

February 15, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, my name is Carrie Dwyer, and I am general counsel of The Charles Schwab Corporation. I am pleased to be here today to represent our perspective on an issue that has direct consequences for the individual investors we serve.

Charles Schwab is one of the nation's largest financial services firms and for more than three decades, our focus has been serving individual investors. We provide them with convenient and efficient access to the markets, and the information and tools with which to make informed investment decisions. Today we serve more than 7.3 million client accounts with nearly $1.1 trillion in client assets. Our customers can trade by phone, through automated voice channels, at a branch, and, of course, online through the Internet. During the fourth quarter of 2004, our clients made an average of 177,000 equity trades a day, as well as about 70,000 mutual fund trades each day. On an average day, our customers trade about 3.5 million shares on the

NYSE and Nasdaq combined. Whether investing in the stock market directly, or investing indirectly through investment advisors and mutual funds, our customers' investment returns are dependent on efficient executions. Our customers demand ever greater efficiency, better service, and lower prices. We believe a regulatory structure that promotes vigorous competition between markets will generate the innovation that will deliver those benefits to them.

The National Market System as a concept was created by the 1975 Amendments to the Exchange Act. Those amendments were the result of a 10-year study and debate here in Congress about the principles which should govern a National Market System. The historic conclusion then was to reject a government-designed central market. Congress determined that the National Market System should evolve through the interplay of competitive forces, and that the SEC's role would be limited to "facilitating" the objectives of the Act where competitive forces were determined to be insufficient. The people sitting in your seats then knew that they could not foresee all of the ways in which technology and investing would evolve, or choose which competitors should succeed and which should fail. They did not believe that a government agency would be in the best position to make those choices either. The decision to allow markets to evolve and adjust through competition has served us well over the years, fostering the highly efficient and technologically advanced markets we enjoy today.

Nevertheless, finding that balance has never been easy; we seem to come together every five years or so to debate centralization and uniformity versus competition and innovation. Removing entrenched anticompetitive barriers has not been easy either. Before the trade through rule, there was the infamous off-board trading rule, which took the SEC over 20 years to remove from the books.

Regulation NMS and the proposals for expansion of the trade-through rule, whether top-of-book or depth-of-book, represent a fundamental redesign of the equity markets. In this proposal, the Commission seeks to substitute its own algorithm for the interaction of competitive market forces: Regulation NMS specifies the order routing algorithm for every broker and every type of customer, specifies new order types to be used on every market, and specifies linkages, response rates, quote volatility tolerances, and a myriad of other details for order routing. This is design, not facilitation.

By specifying a single order routing algorithm, the Commission has in effect designed a central market system that extinguishes the present and future benefits of competition and innovation. Brokers will be forced to route to markets that may not necessarily get the customer the best overall price, and which they would otherwise seek to avoid because of old-fashioned order handling procedures, cumbersome technology or capacity and reliability concerns. Should this design be adopted, there will be no incentive for markets to compete on how orders are executed or how they discover prices or depth because exchanges are guaranteed to receive orders no matter how moribund their technology. Without an incentive to innovate, technological and operational efficiency will be the inevitable casualties.

As numerous buy-side and sell-side firms have pointed out, with every broker forced to route to the same market to take out the same quote when they trade, there is also a serious risk of market gridlock. With the advent of efficient trades over the Internet, our customers have grown used to getting the price they see on the screen within seconds of entering the order. What will we say to them when their orders start taking longer to execute, and at worse prices?

What is the basis for such radical change? It is hard to find a solid empirical basis in the Commission's release. Many of the commenters on the Commission's release have cast doubt on the thoroughness of the Commission's analysis and conclusions.

Is the rationale for a trade through rule the quality of effective and quoted spreads? Our experience with our own order flow has shown us market quality improvements in the transfer just last fall of the QQQQs from the listed markets, which have a trade through rule, to NASDAQ, which does not.

Is the rationale high rates of trade-throughs? The Commission's own reported rate of trade-throughs (about 2%) seems too small to justify changing how the other 98% of orders are handled. And other commenters have found that the actual incidence of trade-throughs is significantly lower. In any case, the Commission reports that the trade-through rate is about the same for NYSE and NASDAQ, despite their differences in market structure.

Is the rationale to encourage greater use of limit orders? The SEC offers no evidence that will be the result. Our own customers choose to enter limit orders on NASDAQ, which has no trade through rule, at twice the rate they do on the NYSE.

Don't be misled by those who will argue that a trade-through rule is merely about requiring that customers get the best price. That is a stalking horse. From the customer's perspective, the issue is not whether the first part of their order is being executed at the best quote; the issue is whether they are getting the best price overall, for their whole order. There

are so many more factors that go into that analysis, such as speed and ability to discover additional liquidity for an order. Regardless of which variation of the trade-through rule it adopts, the SEC's proposal will result in situations in which individual investors do not receive the best price for their trades. This stands in direct contrast to both the current regulatory requirement for best execution, and the commitment that Schwab has made to its customers. Indeed, the trade-through rule now in effect on the exchanges predates all of the best execution rules, tools, execution quality data and other resources that have been developed over the past nine years to ensure customers are getting best execution. The bigger question is whether we should trust the formula for what is best execution to a single, government designed, one-size-fits-all algorithm, rather than to brokers and markets all competing to offer state-of-the-art execution protocols tailored to the unique needs of individual and institutional customers.

The SEC's experimentation with a new design for our equity markets stands in striking contrast to its slow response to a well-documented structural problem that has continued to disadvantage investors.

Under current SEC rules, the securities exchanges operate as a cartel to fix the price of market data and restrict access to data – to the detriment of investors, but especially individual investors who cannot afford the hundreds of dollars a year that the exchanges charge for access to quote services that display market depth information. Right now, individual investors generally only have access to what's called the National Best Bid and Offer, just the two best quotes among all the markets. But these prices are often good for only a few hundred shares. The professionals, on the other hand, can see the level of trading interest at each price level.

Without access to information about market depth, how are individuals going to gauge the prices they will likely get, how and when they should enter their orders, and whether they received best execution? Needless to say, access to quality market data is vital to the functioning and fairness of our markets. Congress, in establishing the National Market System, noted that the market data system operated as a public utility, and said it should be regulated as such. Yet despite five years of study, comment, re-study, re-comment, and debate, the Commission proposes only a "first step" that merely reapportions the pool of money and does not address the root cause of the problem and the inequities it creates.

Mr. Chairman and Members of the Committee: Facilitating competition means eliminating barriers to competition (such as the trade-through rule) that guarantee a market will receive business even if it refuses to evolve. And it means facing up to cartels that place individual investors at a disadvantage. Regulation NMS represents a step that requires reconsideration by the Commission with the thoughtful input of this Committee. While Congress has traditionally respected the SEC's historic role in terms of market oversight, it has consistently reaffirmed that competitive market forces should shape market structure – and it should do so again.

Thank you for allowing me to share our views – I look forward to answering any questions.

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NASDAQ

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Testimony of

Mr. Robert Greifeld
CEO and President
The Nasdaq Stock Market

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and GSEs

February 15, 2005

Chairman Baker and Ranking Member Kanjorski, thank you for this opportunity to discuss NASDAQ's views on the re-proposed version of Regulation NMS.[1]

I. Summary Position on Proposed Regulation NMS

NASDAQ supports the goals of proposed Regulation NMS -- investor protection, enhanced competition, and transparency. And, we feel the proposal makes major strides towards achieving these goals. Moreover, NASDAQ commends the Securities and Exchange Commission (the "Commission" or the "SEC") for its focus on intermarket access standards, sub-penny trading, data revenue distribution, and reform of the trade-through rule.

In fact, NASDAQ supports much of proposed Regulation NMS, includin the restrictions on sub-penny trading, the proposed access standards, and restrictions on access fees. While we are cautious about government imposed limits on fees, we think the current direction Reg. NMS takes in requiring participants to access certain quotes, demands such a limitation to protect investors. Most importantly, we applaud the impact the SEC's acces standards will have on speeding the demise of the outmoded anticompetitive ITS system.

With regard to the SEC's proposal on market data, we support the SEC's liberalization of proprietary market data and the likely enhanced competitive environment that will result from this liberalization. We support the SEC's desire to change the way market data revenue is distributed by th various market data plans. However, we, along with the majority of

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1 Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Second Regulation NMS Proposing Release").

commenters, believe that one element of the proposed formula that governs how market data revenue is distributed, the element known as the "Quote Credit" is seriously flawed and will be gamed by market participants.

Finally, with respect to the much debated topic of the trade-through rule, our position remains unchanged. NASDAQ opposes the trade-through rule because it is not needed, it is costly and, ultimately, it will not serve the best interest of investors. We are proud of the market quality experienced by investors every day on the Nasdaq Stock Market. We achieve that high quality without the anticompetitive effects of a trade-through rule. Investors have been, and will continue to be, protected from inferior executions by the strict application of, and surveillance for, broker-dealer best execution obligations and by competition. On the NASDAQ market, trade-through rates are minimal. We do not believe that extending the trade-through rule to NASDAQ is supported by the facts and may indeed be harmful to investors.

Philosophically, NASDAQ believes that no government decision maker, no matter how well-intentioned, is equipped to make the minute, technical judgments that are now handled by technology and competition in routing and executing millions of trades and billions of shares every day. Simply put, NASDAQ's primary concerns with Regulation NMS, as currently proposed, reflect our belief that market forces and best execution must serve as the bedrock principles to serve public purposes in the securities markets.

Nevertheless, we recognize that the SEC has moved forward with its market structure thinking. Allowing investors to make distinctions between fast and slow markets will help modernize our overall market structure. While repealing the trade-through rule would be a simpler way to achieve a competitive, pro-investor national market system, the advances proposed by the Commission with regard to floor-based markets are groundbreaking. Its proposal is driving floor-based markets to automate today. This proposal will enable electronic markets to compete and will offer investors a better opportunity for best execution than they currently have today. This contribution to the national market system is significant and worthy of praise.

II. Exempting "slow" quotes from the trade-through rule is a good step towards bringing competition to floor-based markets but the trade-through rule should not be extended to NASDAQ.

The Commission's work on the trade-through rule, reflected in the incentive given for markets to adopt electronic quotes, is a step forward and represents a competitive improvement within the NYSE listed space. Although NASDAQ prefers repeal of the trade-through rule, the fast-slow quote designation will have a dramatically positive effect. Inexplicably, however, Regulation NMS has evolved from an endeavor to bring competition to the NYSE space into an effort to impose a trade-through rule on the competitive, pro-investor NASDAQ market.

Application of the trade-though rule to Nasdaq-listed securities would be harmful to investors. The NASDAQ market is already a quality market. We are not convinced that the rule would even achieve the SEC's desired goal of increasing the use of limit orders. In contrast, we know that the rule will impose financial and technical costs and deprive millions of investors of the ability to determine for themselves what is best for them. Furthermore, the Commission studies used to justify extending the rule to NASDAQ significantly overstate the current extent of trade-throughs in the NASDAQ market and makes faulty assumptions about the functioning of the market.

A. Proposed Regulation NMS replaces investor choice with regulatory mandate.

Promoting transparency, disclosure, competition and investor has been the Commission's guiding principle when regulating secondary market trading of equity securities. Soon after being given the statutory mandate to foster a national market system, the SEC adopted rules to require the collection and dissemination of quotes and trade reports of certain over-the-counter ("OTC") equity securities. With access to this information investors could now determine whether the prices they were paying were fair. The SEC exposed OTC trading to some sunlight and in effect deputized millions of investors to protect themselves.

This empowerment of investors leverages the SEC's assets and is facilitated by a broker's duty of best execution - brokers must place the interests of their customers ahead of their own and seek the most advantageous terms reasonably available under the circumstances. This rule provides a legal foundation that ensures each investor - big or small - will hold the broker accountable for achieving what that investor believes is the best price for that investor's circumstances.

To further empower both the investor and regulator, the SEC recently required brokers and markets to disclose order execution quality statistics and descriptions of how they handle customer orders, again applying the information and disclosure principle. Throughout its years of study and review of secondary market trading, the SEC has not created a bright-line test for determining what constitutes best price or best execution. Instead, it has used this well accepted legal concept that keeps brokers and markets vigilant in performing the best they can for their customers.

Competition has also played an important role in ensuring that investors receive quality service and executions. Nowhere is the power of competition more evident than in the trading of Nasdaq-listed securities. - where competition fostered by the SEC and its policies has driven

phenomenal advancement in technological innovation and customer choice.[2] It is by no means inconsequential that all of these innovations and benefits developed only in the market that was free from the competitive distortions of a trade-through rule.

The combination of informed choice, competition, and regulatory oversight has served investors and the national market system well. Despite the quality and efficiency demonstrated by the NASDAQ market, the Commission is proposing to impose the trade-through rule on NASDAQ.

The Commission relies on two economic studies conducted by its staff to support application of the trade-through rule to Nasdaq-listed securities. NASDAQ respectfully disagrees with the Commission staff studies. NASDAQ is responding to these studies in detail. Our full analysis is attached as Exhibit 1 to my testimony.[3] In general, however, the Commission staff studies significantly overstate the current extent of trade-throughs in Nasdaq-listed securities and erroneously conclude that differential fill rates for large marketable limit orders in Nasdaq-listed and NYSE-listed stocks are evidence of a defect in NASDAQ's market structure. Surprisingly, the Commission staff's conclusion with respect to fill rates for large marketable limit orders fails to consider a widely used order routing technique of intentionally sending oversized orders at displayed quotes searching (also known as "pinging") for reserves within the many limit order books trading Nasdaq-listed securities. Thus, this trading device produces orders that are never fully expected to be completely filled. The SEC study ignored these orders when compiling our fill rate, which would be much higher otherwise.

In proposing to retain a modified trade-through rule for exchange-listed securities and expanding it to include Nasdaq-listed securities, the Commission will be transforming its role from that of a referee of the national market system - acting when necessary to ensure the protection of investors - to an active, moment to moment player in the national market system, controlling nearly all aspects of interaction in the system (e.g., recording response times, judging access standards, and setting access fees). This transformation is an unavoidable corollary to the Commission's underlying decision on the trade-through rule. This allows the trade-through rule to grant millions of momentary monopolies. A momentary monopoly is created because the rule distorts the competitive balance by, for the most part, requiring investors to interact with whomever is displaying a protected quote. These momentary monopolies are wholly unnecessary for the NASDAQ. With respect to NYSE-listed securities, the lack of competition and innovation in

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[2] Competition has also led to innovation and greater responsiveness to investor needs. Examples include NASDAQ's opening and closing crosses, anonymous trading, routing, and the multitude of order types that NASDAQ and other markets provide.

[3] *See* Exhibit 1. *Re-Proposed Regulation NMS; File No. (S7-10-04), Nasdaq Comments on SEC Staff Studies*, Nasdaq Economic Research, The Nasdaq Stock Market, Inc., January 25, 2005.

the market for NYSE-listed securities is the direct result of the competitive distortions that the current trade-through rule causes. Therefore, modification of the current trade-through rule to allow differentiation between automated and non-automated will introduce some needed competition into the NYSE market.

B. Choosing between the "Market BBO" and "Depth of Book" trade-through rule alternatives ignores the optimal policy choice of whether a trade-through rule should be applied at all.

Many in Congress have asked NASDAQ what we think of the two alternatives in the latest NMS proposal. Just to be clear – neither a top of book or depth of book version of the trade-through rule seems better than the NASDAQ open competitive model without the trade-through rule. The real question is: Has the trade-through rule outlived its usefulness and should it be repealed?

For those who do support a trade-through rule, however, we have found it interesting that the arguments relied upon conveniently evaporated from their advocacy when the depth of book alternative was proposed by the Commission. In fact, some seem to be taking intellectually inconsistent positions. This was evident when NYSE last testified before you on February 20th at the New York Field Hearing. You will remember Mr. Thain's "best price rule" arguments. He said:

> "The principle behind the trade-through rule is, in my view, critical to protecting investor interests. Why should investors ever receive anything other than the best price? There is talk of the importance of speed, anonymity, and other factors. But in a commoditized market like that which exists for equities, if displayed prices across all markets are available immediately, there is absolutely no reason to allow agents to buy and sell on behalf of their clients for anything other than the best price."[4]

However, by January 12 of this year, the NYSE seems to have had a change of heart. In a letter to the SEC, the NYSE was praising the virtues of "promoting investors' ability to choose among alternative trading venues" and decrying that "mandatory Depth of Book routing eliminates intermarket competition by giving any limit order, regardless of where it was placed, the same protection."

If you really worship at the altar of best price, the depth of book alternative fulfills that objective better and more completely than the Market

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Testimony of John A. Thain, Chief Executive Officer, New York Stock Exchange, Inc.. Capital Markets Subcommittee of the House Financial Services Committee held February 20, 2004. Field Hearing entitled "Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace."

BBO alternative. If someone supports a trade-through protection for one price, how can one logically argue against protection of an order as little as one penny away from that price? That is saying that the first investor in line deserves to have his or her spot protected but the second person in line, and any subsequent people in line, do not.

Those who oppose the depth of book alternative have cited the importance of competing market fill rates, competition and factors other than price as important investor casualties of a depth of book alternative. Of course, these are the very same public policy rationales upon which opponents of the trade-through rule rely.

Moving from the theoretical to the practical, however, we must mention that the practical implications of a depth-of-book trade-through rule would be extremely complex to implement and fraught with the potential for unintended consequences. Therefore, while we empathize with the philosophical rationale for full-book trade-through protection, the practical implications are overwhelming and the rule would create tremendous market structure complexity without accomplishing any tangible investor benefits that trade-through repeal would not.

C. Reforming the trade-through rule and the NYSE's hybrid market proposal

With respect to exchange-listed securities, the re-proposed Regulation NMS would be a definite improvement over the status quo, because the proposal acknowledges the value of speed and certainty of execution and allows electronic markets to compete at electronic speeds. By forcing the NYSE and other manual markets to automate, Regulation NMS would advance the goals of the national market system by enhancing competition in these markets. Manual markets will no longer be the weak link in the national market system, slowing down faster markets while humans - some with a distinct time and place advantage on the floor - attempt to execute orders. The "Fast vs. Slow" quote distinction has guided behavior in the NASDAQ market for some time, absent any guidance from the Commission.

In response to the Commission's proposed Regulation NMS, the NYSE has also proposed a substantial change to its own market structure rules. A side by side comparison of the NYSE's hybrid market proposal and Regulation NMS creates some uncertainty as to how these two fundamental market structure proposals will work together, and whether the NYSE's proposal allows even the limited competitive benefits of Regulation NMS in the listed market to be achieved.

For example, NASDAQ understands that the exception from the trade-through rule for market re-openings will include re-openings after a market has halted trading due to an order imbalance. As discussed below, this will provide the halted market an advantage over markets that continue to trade.

Furthermore, it is unclear what will be considered a re-opening under the NYSE's hybrid market proposal. For example, is trading on the NYSE considered halted each time a liquidity replenishment point is reached or when the specialist gaps the quotes in a security? If so, the NYSE will be able to ignore the quotes of other markets each time it returns from these halted states.

Furthermore, if re-openings are limited to an order imbalance, what kind of discretion does a market have to declare an "imbalance." In addition, is the NYSE free to change its rules concerning what types of orders create an imbalance? Is NASDAQ permitted to propose similar imbalance rules for market makers faced with large order imbalances on their desks? To provide market participants an opportunity to fully review and comment on both the NYSE hybrid proposal and re-proposed Regulation NMS, the proposals must be considered serially. Because the NYSE proposal is intended as a response to Regulation NMS, if the Commission adopts Regulation NMS, it should require the NYSE to resubmit the hybrid rule filing with a detailed explanation as to how it will operate and comply with the new regulation.

As mentioned above, the interpretation of what constitutes a market re-opening may provide halted markets an unfair competitive advantage. By allowing markets to trade-through other valid quotes during a re-opening after an imbalance or other market-specific non-regulatory halt ("non-regulatory halts"), the Commission creates a significant loophole in its own rule that works singularly to the advantage of manual markets. Once a market has declared a halt, market participants know they can execute orders on the re-opening market without regard to trade-through restrictions. Market participants electing to send orders to the halted market will in effect be electing to opt-out of trade-through protection, to the detriment of those displaying quotes and orders on other markets. This creates a disincentive to posting quotes and sending orders to other markets that continue to trade. Accordingly, if the trade-through proposal is adopted, markets re-opening after non-regulatory halts must be required to provide trade-through protection to the protected quotes of other markets.

III. Market data rules should be simplified to embrace competition, end gaming by market participants, and reduce costs to investors.

NASDAQ supports much of the Commission's pro-competitive liberalization of the rules governing distribution, consolidation and display of core and non-core market data by self-regulatory organizations ("SROs") and other market participants. However, the Commission has failed to extend that pro-competitive principle to the government-mandated market data plans, which stifle competition and raise the cost of market data for all investors. If the Commission is content simply to tinker with the Plan Allocation Formula, Nasdaq suggests that it adopt a simpler formula based entirely on proportionate dollar volume or proportionate share volume, and

forego its Quoting Share proposal, which makes the formula needlessly complex and more vulnerable to manipulation.

A primary objective of the national market system is to provide investors with accurate and timely market data with which to make informed investment decisions in a cost-effective manner.[5] The Commission's paramount mission should be to safeguard the integrity of this "core" market data while striking a balance between competition and regulation to ensure a vibrant, accessible market for additional "non-core" market data. To the extent re-proposed Regulation NMS embodies such an approach, NASDAQ is in full support. NASDAQ welcomes the Commission's attempts to increase investor choice and market competition by proposing to reduce the data that vendors are required to display and the instances in which they must display it ("Display Amendment"), and by liberalizing the current restrictions on independent distribution of data outside of the national market system plans. The added competition will inevitably lower average investors' market data costs.

NASDAQ opposes, however, the proposal to re-engineer the Plan Allocation Formula in its current form. While elements of the proposal are consistent with the Commission's mandate to ensure data integrity, an over-emphasis on re-allocating revenue among SROs would place investors at risk of higher-cost and lower-quality data. In particular, the inclusion of a "Quote Share" component in the formula still leaves ample opportunities for manipulation that could cost investors even more than current practices. Adopting the proposed Quote Share element will motivate market participants to adopt artificial trading practices that distort core market data and increase investor costs by forcing national market system plans and vendors to purchase added distribution capacity.

The Commission's Quote Share proposal would lead to increased quotation activity as market participants chase valuable quotation credits in SRO member revenue sharing programs. For example, the Commission can expect innovative competitors to do some of the following:

- ***Flickering Quotes***: displaying quotations just long enough to earn quotation credits but not long enough to risk execution;
- ***Security Targeting***: generating quotations in securities where each quotation credit is proportionately more valuable;
- ***Market Targeting***: generating quotations on markets with little or no resident liquidity to minimize the risk of order interaction;
- ***Shredding Quotes***: generating multiple quotations in a single market, single quotations in multiple markets, or multiple quotations in multiple markets to slow the pace of executions

[5] *See, e.g.,* Exchange Act §11A(a)(1)(C)(iii), (D).

and thereby prolong the period in which quotation credits are earned; and

- ***Shifting Quotes***: moving quotations from one market to another to lengthen the chase by potential contra parties and thereby earn additional quotation credits.

The Commission must simplify the formula further to neutralize the potential for harmful economic incentives that the Allocation Formula could create. The simplest, fairest and most transparent Plan Allocation Formula would be based solely on share or dollar volume of trading activity, a metric the Commission has already endorsed by incorporating it into the square-root dollar volume Security Income Allocation method. Share volume and dollar volume are simple and transparent to calculate, would not motivate market participants to alter their quoting or trading behavior, and cannot be inexpensively manipulated by market participants to maximize their draw on member revenue sharing programs.

IV. We Need a Consensus Rule to Modernize Our Nation's Market Structure.

NASDAQ respects the efforts of the Commission to deal with this tough and complex issue. Let me reiterate that NASDAQ supports a great number of the proposals contained in Regulation NMS. We have seen some thoughtful comments from market participants on the proposed rule and are hopeful that Commissioners are still evaluating all the information placed on the record. We also sincerely appreciate this Subcommittee's interest in market structure issues and believe that this hearing will reinforce the notion that this major undertaking requires thoughtful deliberation

In the end, NASDAQ is hopeful that Reg. NMS is completed in a timely manner. It is important to move competition forward in the trading of NYSE issues, and the current rule process seems to be heading in the right policy direction. Again, we hope the Commission will reject the imposition of any trade-through rule on NASDAQ. The Commission's market structure rules are critical to maintaining U.S. superiority in the global equity markets, and will impact the way Americans and all investors view the quality and fairness of our equity markets. Finally, we would urge consensus decision-making, which is an indicator of a fair process and will yield the best rules.

In conclusion, I would like to take this opportunity to address another issue that relates to the national market system. I would like to compliment the Commission on working with NASDAQ on our exchange registration application. Commission staff publicly stated at the SEC December 15 open meeting that a solution is at hand on the NASDAQ application, and that the application could be considered expeditiously. The Commission has worked hard and in good faith with NASDAQ, and we appreciate their commitment to finding a solution that would enable NASDAQ to register as an exchange. I also would like to thank many of you for expressing support for NASDAQ's

exchange registration in the past. Approval of the application will separate our regulator from our market, strengthening integrity of our market.

Thank you for holding this hearing and considering NASDAQ's views.

Report in Support of Testimony by

Mr. Robert Greifeld
CEO and President
The Nasdaq Stock Market

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and GSEs

February 15, 2005

NASDAQ®

Prepared by

Nasdaq Economic Research

The Nasdaq Stock Market, Inc.

February 12, 2005

EXHIBIT 1

Executive Summary

In re-proposing Regulation NMS, the SEC concludes that trading in both Nasdaq- and NYSE-listed stocks would benefit from strengthened protection against trade-throughs." In reaching this conclusion, the Commission cites one study of trade-throughs and three studies of market quality as providing the necessary supporting data. While each study has its own unique purpose in supporting the proposed rule, Nasdaq believes that each also contains a flaw in conceptual design, data selection, or execution that undermines its findings. In this appendix, Nasdaq offers our analyses of these four studies. To summarize:

- The goals of the Trade-Through Study were to characterize trade-throughs for both Nasdaq and the NYSE and to explore the effects of competition on the frequency of trade-throughs in Nasdaq-listed securities. The study uses 2003 data and fails to acknowledge advances in the Nasdaq-listed trading environment during 2004 that have lowered the trade-through rate in Nasdaq stocks to 1.5%, significantly less than the 2.5% reported for 2003 in the Commission's study. Once large trades and trades during crossed markets are excluded, the 2004 trade-through rate drops to 0.8%.
- In the release, as well as in comments made in the open meeting, the Commission expressed concern about two market quality aspects of Nasdaq stocks, the fill rate of large marketable limit orders and volatility. The SEC went on to argue that a trade-through rule would create an added incentive to post liquidity-providing limit orders that would improve fill rates, lower volatility, and improve market quality.
- Contrary to the release, differential fill rates for large marketable limit orders do not indicate a market defect but reflect the prevalence of reserve size in Nasdaq quotes. Large marketable limit orders execute far more shares, at lower cost, in Nasdaq-listed trading than in NYSE-listed trading.
- The Matched Pairs Study is largely a study of small stocks. The SEC compares market quality of 113 pairs of Nasdaq and NYSE stocks. Over a quarter of the stocks are not NYSE eligible and only 10% are from the Nasdaq-100. Even for these small stocks, the study shows that Nasdaq market quality is on parity with the NYSE.
- The S&P Index Study also compares market quality in Nasdaq- and NYSE-listed S&P index constituent stocks. The study overstates the effective spreads of Nasdaq stocks using a methodology that favors higher priced NYSE stocks and also uses statistics from an atypical month.
- The Volatility Study contains results that Nasdaq cannot reproduce. The SEC's short-term volatility estimates are more than three times higher than Nasdaq's AND higher than those in an NYSE study upon which the SEC study is based.

EXHIBIT 1

I. Introduction

In the release re-proposing Regulation NMS[1], the Securities and Exchange Commission ("SEC" or "Commission") concludes that although the trading environment for stocks listed both on the Nasdaq Stock Market Inc., ("Nasdaq") and on the New York Stock Exchange ("NYSE") has significant strengths, "both markets have weaknesses that could be reduced by strengthened protection against trade-throughs."[2] In reaching this conclusion, the Commission refers to one study of trade-throughs[3] and three studies of market quality[4] to provide the necessary supporting data. We support the Commission in seeking compelling empirical evidence of flaws in the current structure of U.S equity markets before embarking on a program of sweeping reform. In order that the Commission's final decision be based upon as complete and thorough an understanding of the available empirical evidence as possible, we have prepared our own analyses of the four studies and the issues addressed therein. We suggest that the Commission's studies significantly overstate the current extent of trade-throughs in Nasdaq securities and incorrectly characterize execution quality of Nasdaq- and NYSE-listed stocks.

The SEC studies either focus directly on the proposed rule or on the relative performance of the markets for Nasdaq- and NYSE-listed securities. The Trade-Through Study addresses a key point of proposed Regulation NMS and will be considered in detail below. For the market quality studies, Nasdaq unequivocally supports the Commission's efforts to achieve unsurpassed market quality for all investors in U.S. equity markets but we do not accept the argument that any shortcomings in market quality for Nasdaq- or NYSE-listed securities are best addressed by strengthened trade-through restrictions. Nevertheless, Nasdaq has prepared an in-depth analysis of those studies as well.

While each study has its own unique purpose in supporting the proposed rule, each also contains a flaw in conceptual design, data selection, or execution that undermines its findings. In particular, the Trade-Through Study uses out-of-date data from the Fall of 2003, both the Matched-Pairs Study and the S&P Index Study erroneously describe the marketable limit order fill rate of Nasdaq securities as evidence of a market flaw, the Matched-Pairs Study fails in its stated intent of replicating SEC 2001[5] by omitting

[1] Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004).
[2] 69 FR 77432.
[3] Memorandum from the Office of Economic Analysis, Commission, to File, dated December 15, 2004 (Analysis of Trade-Throughs in Nasdaq and NYSE Issues) ("Trade-Through Study").
[4] Memorandum to File, from Office of Economic Analysis, dated December 15, 2004 (Comparative analysis of execution quality for NYSE and Nasdaq stocks based on a matched sample of stocks) ("Matched Pairs Study"); Memorandum to File, from Division of Market Regulation, dated December 15, 2004 (Comparative analysis of Rule 11Ac1-5 statistics by S&P Index) ("S&P Index Study"); Memorandum to File, from Office of Economic Analysis, dated December 15, 2004 (Analysis of volatility for stocks switching from Nasdaq to NYSE) ("Volatility Study").
[5] "Report on the comparison of order execution quality across equity market structures" U.S. Securities and Exchange Commission, 2001, Washington, D.C ("SEC 2001").

almost all active Nasdaq securities, the S&P Index Study only partially controls for the effects of stock price on trading spreads thereby biasing its results in favor of higher price NYSE stocks, and finally the results of the Volatility Study cannot be reproduced and may be erroneous. We believe that the results from the more complete analyses presented here firmly establish that investors in NYSE-listed stocks would benefit from extending the competitive environment of Nasdaq trading to NYSE securities and that the converse, creating a monopoly at the inside for Nasdaq securities, would be a step backwards for U.S. capital markets and investors.

II. Trade-Through Study

The Commission's Trade-Through Study is designed with the stated goals of characterizing trade-throughs for Nasdaq and NYSE securities[6] and determining whether competition has created a 'no-trade-through zone' in Nasdaq securities.[7] To achieve these goals, the study uses databases prepared by Nasdaq and the NYSE to measure trade-throughs on four Thursdays between September and December 2003.[8] We address a number of issues in this analysis which collectively indicate that the Commission's Trade-Through Study has significantly underestimated the benefits of competition on creating a 'no-trade-through zone' for Nasdaq securities and overestimated the possible gains from proposed Regulation NMS.

Our primary concern is the choice of 2003 for the sample. At that time, there were five independent major electronic market centers for Nasdaq trading: three ECNs and two SROs. Today there are three: one ECN and two SROs.[9] Furthermore, the routing linkages maintained by these markets, as well as routing and matching systems of trading firms and third party vendors, were less developed in 2003 than today. All these changes reflect the power of competitive forces. It would seem reasonable, therefore, to use more recent data not only to capture Nasdaq-listed trading as it exists today but also to be used in conjunction with the 2003 results to determine whether market forces are reducing the rate of trade-throughs over time.

The table below shows the trade-through rate, in trades and shares, for 2003 and 2004 using the Trade-Through Study's methodology.[10] As is

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[6] Trade-Through Study at 1.
[7] 69 FR 77443.
[8] The actual dates are September 18, October 16, November 20, and December 18, 2003. All are Thursdays immediately prior to expiration Fridays.
[9] In 2003 the five electronic major market centers in Nasdaq securities consisted of three major independent ECNs and two SROs; the Island ECN quoting and printing on the National Stock Exchange ("NSX") , Instinet ECN quoting and printing to the NASD's Alternate Display Facility ("ADF"), BRUT ECN quoting on Nasdaq and printing to the Boston Stock Exchange ("BSE"), as well as Nasdaq and ArcaEx. Today, there is one major independent ECN and two SROs; INET ATS resulting from the merger of the Island and Instinet ECNs and quoting and printing to NSX, Nasdaq which acquired the BRUT ECN, and ArcaEx.
[10] We employ the methodologies of the Trade-Through Study, particularly the three-second sample window. Sample dates remain Thursdays before expiration Fridays, September 16, October 14, November

EXHIBIT 1

readily apparent, the 2003 trade-through rate significantly overstates the current 2004 rate (1.5% today vs. 2.5% a year ago). In addition to the decline in the overall trade-through rate, every major electronic market center shows a decline in its individual trade-through rate.[11]

Nasdaq-Listed Trade-Through Rates by Executing Market Center

	% Trades			*% Shares*		
Market	Late 2003	Late 2004	Change	Late 2003	Late 2004	Change
Amex	26.4%	40.6%	*14.2%*	38.1%	56.6%	*18.5%*
Boston	0.6%	-	-	0.3%	-	-
National	2.0%	1.4%	*-0.6%*	1.9%	1.3%	*-0.6%*
NASD ADF	3.0%	0.6%	*-2.4%*	3.1%	0.2%	*-2.9%*
Chicago	7.1%	4.8%	*-2.3%*	18.9%	33.2%	*14.3%*
Pacific (ArcaEx)	1.6%	1.4%	*-0.2%*	1.7%	1.3%	*-0.4%*
Nq-SuperMontage	3.4%	1.8%	*-1.6%*	2.9%	1.6%	*-1.3%*
Nq-Internalized	3.2%	1.4%	*-1.8%*	16.6%	13.0%	*-3.6%*
Total	**2.5%**	**1.5%**	***-1.0%***	**7.8%**	**5.9%**	***-1.9%***

Furthermore, competitive forces are not done. Nasdaq, whose Nasdaq Market Center does not currently route orders to market centers external to Nasdaq, acquired the BRUT ECN in September 2004 largely to provide external routing capability to its participants.

The Trade-Through Study indicates that the consideration of trade size is an important methodological issue.[12] The trade-through statistics presented above do not account for trade-throughs that occur when the total trade size is larger than the displayed depth. **When displayed size is taken into account, the Nasdaq-listed trade-through rate for late 2004 declines from 1.5% to 1.0% for trades and from 5.9% to 0.8% for volume.** An important question not addressed in the Trade-Through Study is whether these large trades intentionally avoid interacting with the posted quotes or are part of an execution that 'swept the street' or otherwise interacted with the market.

Of the remaining trade-throughs, the Trade-Through Study does not address changes in trade-through rates likely to result from the access provisions of proposed Regulation NMS, whether the sweep provisions differ

18, and December 16, 2004. We thank the Commission's Office of Economic Analysis for sharing their methodology with us.

[11] The late 2004 numbers are only the most recent results from an on-going trend. Trade-through rates from the dates March 18, April 15, May 20, and June 17, 2004 fall between the late 2003 rates and those reported for late 2004.

[12] Trade-Through Study at 1, 2.

significantly from routing practices today, and the appropriateness of the databases. As discussed below, each of these issues could be addressed with available data and has a significant bearing on the efficacy of the proposed rule, as well as its costs and benefits.

One of the provisions of the proposed access rules is a prohibition on locking and crossing the National Best Bid and Offer ("NBBO").[13] If this proposal is adopted, trade-throughs that result from crossed markets would be significantly reduced if not eliminated. The Trade-Through Study discounts the number of trade-throughs resulting from crossed markets when assessing the need for strengthened trade-through provisions. We disagree with the study's observation that trade-through rates are not materially affected by executions that occur in crossed markets. We estimate that trade-through rates fall to 2.1% in 2003 and 1.3% percent in late 2004 when trade-throughs occurring during a crossed NBBO are dropped.[14]

In addressing the extent to which market centers already practice the equivalent of proposed Regulation NMS sweep orders today, it must be noted that Nasdaq does not currently route to non-participating market centers such as ArcaEx and Instinet's INET ATS. We do, however, observe how often these market centers route orders to Nasdaq. This analysis is complicated by the fact that if a Nasdaq-participating ECN is at the inside, INET or ArcaEx may route to that ECN directly rather than through Nasdaq systems. Limitations of the data notwithstanding, ArcaEx and Instinet are typically among the top three liquidity demanders on the Nasdaq Market Center.

Finally, the databases used (NASTRAQ for Nasdaq trades and TAQ for NYSE trades and both Nasdaq and NYSE quotes) may not be appropriate relative to alternatives such as OATS and other audit trail data.[15] First, NASTRAQ and TAQ represent events as recorded by the Securities Information Processor ("SIP"), not as observed by market centers and traders when deciding whether and where to route incoming orders. Nasdaq maintains internal databases covering routing decisions to participating market centers.[16] Even a small amount of latency can create a measurement problem when using a three-second window to evaluate trade-throughs. An alternative way to measure trade-throughs would be to identify trade-throughs where a market center knowingly traded through based on data available at the time, thereby accounting for network latency. Second, while the databases are believed to be accurate, even small errors in time stamps or other relevant fields may result in mis-measurement of trade-

[13] 69 FR 77447

[14] Our figure represents the fraction of trade-throughs reported to the tape in the same second as the NBBO was crossed. This method differs from that referenced in the Commission's Trade-Through Study at 5 in that the Trade-Through Study requires the market to be crossed for the entirety of the three second window, which is rare.

[15] Trade-Through Study at 8, 9.

[16] Nasdaq systems are incapable of trading through quotes on our book representing participating market centers. It should be noted that the SEC's methodology produces 'false positives' in situations where trades executed by the Nasdaq Market Center are erroneously identified as being outside the Nasdaq Inside.

throughs. Because the number of trade-throughs is small, identifying the fraction caused by data errors becomes more important. Finally, for quotes, TAQ does not identify the order submitter(s). Only audit trail data can reveal whether 100-share quotes being traded through represent retail orders.[17]

Although our comments to this point have focused on the trade-through rate in Nasdaq-listed securities, we would like to highlight one aspect of trade-through rates for NYSE-listed stocks. Tables 4 and 11 of the Trade-Through Study break out trade-through rates by dollar volume rank. For Nasdaq stocks, the Commission study reports trade-through rates decrease from 2.9% to 2.3% across the top four dollar volume ranks reported in Table 4. In the top row of the table below are the comparable rates for NYSE-listed stocks as calculated in Table 11 of the Trade-Through Study. NYSE trading shows a much greater range of trade-through rates, from 5.4% to 1.2%. We have also included the average time at the National Best Bid and Offer for the NYSE and the average for Nasdaq and ArcaEx combined.[18] The table shows the much higher than average trade-through rate for active NYSE stocks and the very strong correlation between quote competition and trade-throughs in NYSE securities. Apparently, where there are few competing quotes to trade through, NYSE stocks only trade through about 1% of the time. But in the limited set of stocks where active quote competition exists, the best price is much more frequently ignored.

Quote Competition and Trade-Throughs in NYSE-listed Stocks

	Dollar Volume Rank			
	Top 20 Stocks	Stocks 21-100	Stocks 101-500	Stocks 501-1000
Trade-Through Rate (SEC Study Table 11)	5.4%	3.9%	1.8%	1.2%
Nasdaq / ArcaEx Time at Inside Quote	28.1%	25.2%	9.4%	5.7%
NYSE Time at Inside Quote	79.6%	82.9%	92.4%	92.4%

The goals of the Trade-Through Study were to characterize trade-throughs and to explore the effects of competition on the incidence of trade-throughs in Nasdaq-listed securities. Nasdaq believes that competitive forces have significantly lowered trade-through rates in Nasdaq-listed securities since the 2003 period studied by the SEC. Furthermore, many of the trade-throughs identified in Nasdaq-listed securities occur as the result of crossed markets, are large trades, or occur simultaneously with routed orders. Trade-throughs of these types will either disappear under other provisions of

[17] 69 FR 77433.

[18] For simplicity in calculations, we did not estimate time at the inside for other market centers in NYSE-listed stocks.

proposed Regulation NMS or will continue to occur much as they do today but in compliance with the proposed rules. Nasdaq also notes that the trade-through rate in NYSE-listed stocks with active quote competition is much higher than for similarly active Nasdaq stocks and much higher than for inactive NYSE stocks with little quote competition. Consequently, Nasdaq argues that competitive forces are achieving the goals envisioned by strengthened trade-through restrictions for Nasdaq securities; and if there is any market structure failure evident from the Trade-Through Study, it is for NYSE trading where competition has not lowered trade-through rates.

III. Limit Order Fill Rates

The goal of the staff studies is to provide empirical evidence of defects in Nasdaq- or NYSE-trading that are best addressed by strengthening trade-through restrictions. In the text of the Regulation NMS re-proposing release, as well as in comments made during the December 15 hearing, the Commission expressed concern about the fill rate of large marketable limit orders in Nasdaq-listed stocks.[19] The SEC goes on to argue that a trade-through rule would create an added incentive to post liquidity-providing limit orders that would allow more shares of larger marketable orders to be filled.[20] Nasdaq disagrees with the Commission's conclusion. We do not believe that two isolated statistics, out of the more than 240 statistics in Rule 11Ac1-5 ("11Ac1-5" or "dash-5") reports, provide evidence of a market defect. Nor do we believe that the staff studies identify a lack of liquidity for large orders or establish the value of trade-through restrictions in enhancing liquidity for large orders.

Nasdaq stocks provide a hospitable environment for large marketable limit orders. Compared with the NYSE peer stocks in the Matched Pairs Study, far more shares of marketable limit orders are *executed* for Nasdaq stocks, and done so at prices equal to or better than for NYSE stocks. The fill rates referenced in the release are the result of much greater submission of 11Ac1-5 covered shares for Nasdaq. What presumably matters to submitters of marketable orders is the number of shares *executed* and the *price*, not just the fill rate of a single order.

On the electronic venues trading Nasdaq stocks, it is common for submitters of non-marketable limit orders and quotes to use hidden "reserve" size. This size can be revealed only when the orders are traded against. Traders submit oversized orders priced at the inside quote to take advantage of the possibility of reserve size being available. There is no harm in doing so since none of the electronic markets charge a commission on unexecuted shares, and the presence of a large marketable order is undetectable by other traders. It is our understanding, by contrast, that electronic orders submitted for NYSE stocks over the SuperDot system do not have similar reserve size capability although floor orders may only be partially displayed.

[19] 69 FR 77432-77433
[20] 69 FR 77433

If a trader on the NYSE submits an oversized large marketable limit order priced at the opposing inside quote, that submission can be observed by the specialist and floor brokers in the trading crowd.[21]

Another difference between the two markets is the different handling of Immediate-or-Cancel or IOC orders which are included in 11Ac1-5 data as limit orders. In electronic venues, an IOC order can interact only with orders already standing on the electronic book. On the floor, a large IOC order can interact with any interest already on the floor and is not limited to orders on the electronic book. Consequently, a large IOC order sent to a floor grants a free option to those on the floor whereas there is effectively no free option value from an IOC submitted to an electronic book. The lack of a free option, as well as the avoidance of disclosure risk cited in the previous paragraph, makes marketable IOC limit orders exceedingly popular in electronic venues where they have effectively supplanted market orders as the order of choice in accessing available liquidity at the current price.

With these points in mind, reconsider the results of the Commission studies. Table 10 of the Matched Pairs Study illustrates a difference in fill rates for large marketable limit orders. For the "Large" market capitalization category, the Matched Pairs Study reports that Nasdaq's fill rate is 20% versus a rate of 66% for NYSE. A more complete view of marketable limit order executions is shown in the following table, which is similar to Table 3 in the Matched Pairs Study.[22] For large marketable limit orders in the "Large" market capitalization group, 1,032 million Nasdaq shares are filled compared with only 332 million NYSE shares, a factor of three difference. In fact, among all size/market capitalization categories, there are many more Nasdaq shares of marketable limit orders filled than NYSE shares.

[21] Under Direct+ rules in effect during the time of the SEC's study, any order in the 11Ac1-5 large marketable limit order categories could not have been a Direct+ order.
[22] The table uses the same sample months and sample stocks as the Matched Pairs Study. The table adds two data elements, the total number of covered shares, and the shares executed *at the market center*, which excludes shares that are routed away from the market center for execution.

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11Ac1-5 Shares of Marketable Limit Orders for Matched Pairs Sample

(January – June 2004, all Market Centers, millions of shares)

		Large Mkt Cap		*Medium Mkt Cap*		*Small Mkt Cap*	
		Nasdaq	NYSE	Nasdaq	NYSE	Nasdaq	NYSE
100-499 Shares	Covered	3,079	1,236	601	349	246	158
	Executed	2,019	792	476	252	194	119
	Executed at MC	1,550	742	350	241	142	115
500-1999 Shares	Covered	5,836	2,319	899	427	381	194
	Executed	3,066	1,584	561	325	233	149
	Executed at MC	2,452	1,451	443	302	182	142
2000-4999 Shares	Covered	3,014	727	567	165	258	99
	Executed	1,449	545	247	121	117	72
	Executed at MC	1,154	530	197	117	94	70
5000-9999 Shares	Covered	4,469	474	687	113	296	70
	Executed	1,033	333	157	75	67	45
	Executed at MC	832	324	125	72	54	43

The above table shows that for Nasdaq stocks, many more covered shares of marketable limit orders are submitted. For the largest order size category and the largest market capitalization group, there are almost 10 times as many shares submitted for the Nasdaq stocks compared with the NYSE peers (4.4 billion compared with 474 million). In terms of (non-routed) executions, Nasdaq-listed exceeds NYSE-listed executions by a factor of about 2.6 (832/324). Thus, the Nasdaq-listed fill rate indeed differs from the NYSE fill rate, but there are substantially more executions. In every order size/market capitalization group cell, Nasdaq-listed executions, adjusting for routing, exceed those of the NYSE peers. Even if one reduces the Nasdaq-listed executed shares, already adjusted for routing, by an additional 30%, as suggested by the Matched Pairs Study, Nasdaq-listed executed volume would still exceed NYSE-listed volume for all data cells except those for the three largest order sizes for the "Small" market capitalization group.

As a technical matter, when comparing total shares executed, it is best to count only those shares executed at the reporting market center. Otherwise, double counting could occur.[23] For example, suppose ArcaEx

[23] Note that the double counting concept just referred to is different than the one used in the Matched Pairs Study. In selecting NYSE peers for its Nasdaq sample, the Matched Pairs Study adjusted downward Nasdaq-listed dollar volume to account for what it termed a "difference in volume reporting between the Nasdaq and the NYSE." The study does not provide details as to why this adjustment is necessary. One possibility would be that the Nasdaq-listed market has a higher level of dealer intermediation than the

receives an order for 5,000 shares, executes 4,000 shares, and routes the remainder to INET, which executes the remaining 1,000 shares. In dash-5 data, ArcaEx would report total executed shares of 5,000, and INET would report 1,000 shares. The grand total of executed shares would be 6,000, which is too high unless one uses as the ArcaEx total the 4,000 shares executed at the market center. Note that the difference between executed shares and executed at the market center shares is higher for Nasdaq-listed than for NYSE-listed. On average, the difference is about 20% for Nasdaq and 5% for NYSE. This implies more inter-market center routing on Nasdaq.

The quantity of shares executed is one measure of a market's performance, another is the price of those executions. The Matched Pairs Study concludes that effective spreads for Nasdaq stocks tend to be lower for larger orders. Specifically, Table 4 shows that for the two largest marketable limit order categories and for all three market capitalization groups, Nasdaq effective spreads are lower than or not statistically different from NYSE spreads, measured either in cents per share or basis points. In sum, rather than demonstrating a market structure defect, Nasdaq trading fills more shares of large marketable limit orders at better prices than the NYSE.

The Commission claims that the fill rate for large marketable limit orders would increase for Nasdaq securities under a trade-through rule. Large marketable limit orders in Nasdaq stocks, however, execute many more shares at more favorable prices than in NYSE trading. The re-proposing release fails to acknowledge that similar order types mean different things and operate in different ways in electronic and floor-based markets. Furthermore, if a defect were found in liquidity for large orders in Nasdaq stocks, the Commission still must establish that a trade-through rule for these stocks is the optimal solution for fixing this supposed market structure defect.

IV. Matched Pairs Study

The Commission's Matched Pairs Study is one of two studies using Rule 11Ac1-5 statistics to compare the execution quality of marketable orders in NYSE- and Nasdaq-listed stocks. As with the S&P Index Study, the goal of the Matched Pairs Study is to evaluate comments regarding execution quality received on the Regulation NMS proposals.[24] Of these two studies, the more detailed and sophisticated is the Matched Pairs Study. It uses a "matched

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NYSE-listed market. Whether true or not, this argument does not apply to dash-5 data, even though the Matched Pairs Study intimates that it does (page 3 of study). Dash-5 shares are shares of orders submitted by investors. How these orders are translated into reported volume is a separate matter. For example, suppose an order for 1000 shares to buy is submitted for a Nasdaq stock to a market maker. The market maker sells the shares and reports volume of 1000 shares. Sometime later, suppose the market maker receives a sell order for 1000 shares. It would buy the shares, and report another 1000 shares of volume for a total of 2000 shares. Dash-5 would report 2000 shares. By contrast, suppose the identical situation had occurred on the NYSE. It is possible that the specialist, holding the first order long enough without an execution, would be able to match it directly with the opposing sell order. Reported NYSE volume would be 1000 but dash-5 volume for the NYSE would be, however, the same 2000 shares as was the case for the Nasdaq market maker.

[24] S&P Matched Pairs Study at 1 and 69 FR 77432.

pairs" methodology to attempt an "all else equal" comparison in which observed differences in market quality are not driven by stock characteristics unrelated to market structure.

The Commission's Office of Economic Analysis ("OEA") has provided Nasdaq with the sample of matched peers that it used in its study, as well as other information related to the construction of the sample.[25] This information has allowed us, to a large extent, to replicate the study. From this information we have determined that the results presented by the Matched Pairs Study are more representative of the experience of smaller stocks. Over one quarter of the Nasdaq sample stocks are not NYSE eligible. Any conclusions on market quality drawn from the Matched Pairs Study should be made with this fact in mind.

The Matched Pairs Study takes an earlier SEC study,[26] released in 2001, as its model.[27] Its basic design is to draw a sample of Nasdaq stocks, then find an NYSE peer for each based on its similarity to the Nasdaq stock along four dimensions, market capitalization, average dollar volume, price, and (non-market structure related) volatility. Given the set of peer stocks, various aspects of market quality for marketable orders - effective spreads, price impact, execution speed - are compared. Table 1 of the Matched Pairs Study provides detail as to the universe of Nasdaq stocks under consideration. Very low priced or inactive stocks were eliminated, yielding a universe of 1,711 Nasdaq stocks from which a sample was drawn. We estimate that these stocks represent 88% of both the market capitalization and dollar volume of all Nasdaq-listed stocks.

At this stage, one might ask how many of the 1,711 stocks would be eligible for an NYSE listing. Nasdaq, using posted NYSE initial listing guidelines, estimates that at the end of 2003 approximately 1,000 Nasdaq listings could qualify for the NYSE. The Matched Pairs Study took no consideration of NYSE listing eligibility when drawing the sample, apparently including some 700 non-NYSE eligible stocks in its sampling universe.

The next step is to order the 1,711 stocks by fourth quarter 2003 dollar volume, and select every 5th stock. Since the distribution of dollar volume on Nasdaq (on NYSE as well) is extremely skewed, the study's sampling procedure yields a similarly skewed sample of stocks—few large stocks and many small stocks. The sample is not representative of investors' trading experience, which is related to trading volume. To correct this sample deficiency, the study adds (again following the SEC 2001 approach) all stocks that were in the top 20 of dollar volume, share volume, or market capitalization. There are 31 unique stocks in the top 20 of the three

[25] Nasdaq thanks the Commission's Office of Economic Analysis for their assistance in preparing this analysis of the Matched Pairs Study.
[26] "Report on the Comparison of Order Execution Across Equity Market Structures," U. S. Securities and Exchange Commission, January 2001.
[27] Matched Pairs Study at 2.

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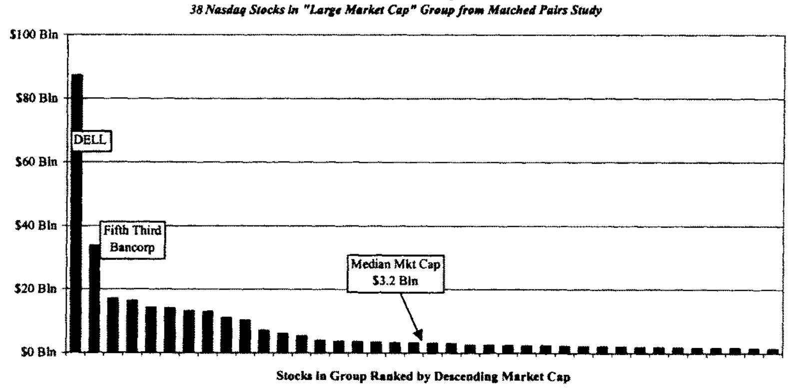
variables. The impact of the "Top 20" addition is largely undone, however, by a final step in the sampling design—the elimination of stocks for which the quality of the match is poor. In this step (which was not part of the SEC 2001 study) the target sample of 368 is reduced to 133 stocks.

Of the 31 "Top 20" stocks, only 9 make it into the final sample. Evidently, large Nasdaq stocks were unlikely to find a good NYSE match, and therefore are excluded. Missing are such marquee names as Microsoft, Intel, Cisco, Applied Materials, Oracle, and Sun Microsystems. Only 15 Nasdaq-100 companies are in the final sample. Ironically, though large Nasdaq stocks are poorly represented, we estimate that about 30 of the final sample stocks are too small to qualify for an initial NYSE listing.

The study proceeds to stratify the results by categorizing each stock pair into one of three market capitalization groups. The problem with the categorization is that it is essentially done the same way as the sampling. The 113 stock pairs are simply divided into three equal groups of about 38 stocks each. The composition of the groups mirrors the skew of market capitalization. It would seem that at a minimum, the remaining 9 "Top 20" stocks should have formed their own category (as was done in the SEC 2001 study). Instead, they were combined into the "Large" market capitalization category. As a result, the distribution of market capitalization in the "Large" category is extremely skewed, as illustrated in the figure below. Since all the summary statistics provided by the study are simple means, the influence in the averages of a stock like Dell, with 28% of the market cap of the group, is only 1/38 (= 2.6%).

Distribution of Market Capitalization

38 Nasdaq Stocks in "Large Market Cap" Group from Matched Pairs Study



The median stock in the "Large" category has a market capitalization of $3.2 billion. For reference, the median market cap for S&P 500 stocks in January 2004 was $9 billion. The median for the S&P MidCap 400, though, was $2 billion. Thus, the study's "Large" category is perhaps better viewed

as a sample of middle capitalization stocks. The study's "Medium" and "Small" categories have median market caps of $800 million and $300 million, which are in line with the median of $620 million for the S&P SmallCap 600.

The Matched Pairs Study compares execution quality across market structures with and without trade-through restrictions. Using six months of 11Ac1-5 data and a methodology designed to produce a sample of small to medium sized stocks with similar characteristics traded on the two markets, the study finds strengths and weaknesses in both markets.[28] This sentiment was echoed in the proposing release. Even ignoring the fact that over 25% of the Nasdaq sample stocks are too small to meet NYSE initial listing requirements and that the great majority of Nasdaq's marquee names are dropped from the sample, the study finds Nasdaq-listed market quality to be roughly in parity with that of NYSE stocks. The only defect claimed to have been identified is the fill rate of large marketable limit orders discussed in Section III. Furthermore, the study provides no evidence that the presence or absence of trade-through restrictions has any effect on the results.

V. S&P Index Study

The Commission's S&P Index Study presents an analysis of Rule 11Ac1-5 statistics from January 2004 comparing execution quality of marketable orders between NYSE- and Nasdaq-listed stocks. The goal of the study is to evaluate execution quality in four groups of stocks based upon membership in S&P indexes. A key advantage of using S&P indexes to form the groups is that the categorization is done by an independent third party, Standard and Poor's, and stocks within an index share certain fundamental characteristics. Further, S&P indexes are well known and accepted among the general public.

We would offer the following two comments on the S&P Index Study as it applies to the analysis of effective spread. Our first comment pertains to the S&P Index Study's apparent goal of controlling for differences in stock price.[29] Table 1 of the study shows that with the exception of stocks in the S&P 100, stocks within the same index are fairly well matched on average in terms of market capitalization. They are not as well matched with regard to average price, however. The NYSE-listed stocks have, on average, higher price levels.[30] The primary innovation of the study, perhaps motivated by the difference in prices, appears to be the presentation of spread results in terms of basis points rather than cents per share. That is, the spread in cents is divided by the share price to convert it to basis point terms. Such a spread measure is often termed "relative spread."

[28] 69 FR 77432
[29] 69 FR 77432
[30] Ibid

As a mathematical necessity, relative spread comparisons using S&P indexes will therefore look more favorable to the higher-priced NYSE stocks than cents-per-share results. Are dash-5 results more accurately conveyed when presented in basis points? The study seems to imply that if a stock on the NYSE has, for example, a price twice that of a Nasdaq stock it could have a cents-per-share spread twice that of the Nasdaq stock, and still be deemed the same. It turns out, however, that as an empirical matter on both markets, cent-per-share spreads do not increase proportionately with share price. In other words, if stock A has a price of $20 and stock B a price of $40, the spread of B will typically have a spread less than twice that of A.

As an illustrative example consider the following two tables. The first is extracted from Table 2 of the Commission's S&P Index Study and presents the relative effective spread of 398 Nasdaq and NYSE-listed securities that compose securities 101-500 in the S&P 500 index as of January 2004. The second table takes the same group of stocks and breaks out the stocks into six price tiers based on the average price of the stock.

SEC Results, Table 2

Small Market Orders, S&P 101-500

Effective Spread (basis points)	
NYSE	NASDAQ
4.9	5.2

Same Data Grouped by Price Tier

Small Market Orders, S&P 101-500

	Issues within Tier (%)		*Eff. Spread (cents)*		*Eff. Spread (basis pts)*	
Price Tier	NYSE	NASDAQ	NYSE	NASDAQ	NYSE	NASDAQ
<= $5	1%	3%	1.0	0.9	23.2	24.7
$5 - $10	2%	9%	1.1	0.9	14.3	14.1
$11 - $20	14%	9%	1.2	1.2	8.0	8.4
$21 - $50	56%	58%	1.8	1.7	5.2	5.0
$51 - $70	16%	18%	2.5	2.3	4.2	3.9
> $70	12%	3%	3.2	4.8	3.9	6.3
All	100% (331 Stocks)	100% (67 Stocks)	2.0	1.6	4.9	5.2

The first point from the larger table is that cent-per-share spreads do not increase proportionately with share price.[31] Nasdaq stocks priced below

[31] Technically, one can speak of the "elasticity" of the spread (in cents) with respect to the share price—the percentage change in spread associated with a one percent change in price. Mathematically, the relationship between spread and price may be expressed as $\log(spread) = a + b \times \log(price)$, where the

$5 have an average spread of 0.9 cents, whereas Nasdaq stocks priced above $70 have an average spread of 4.8 cents. The stock prices differ by a factor of more than 14 but the spreads differ by a factor of approximately five. The second point from the table is the compositional difference in average stock price between the two markets. Nasdaq has more low-priced stocks (12% below $10) and fewer high-priced stocks (3% above $70) than the NYSE (3% below $10 and 12% above $70).[32]

These results imply that while one should take share price into account when comparing spreads, simply dividing the spread by price does not automatically make comparisons any better. A relative spread approach overcorrects for price. Note that this statement is true even if one believes that basis points are the correct metric for measuring trading costs. Under such a belief system, one would accept the empirical fact that higher-priced stocks are simply cheaper to trade than lower-priced stocks on both NYSE and Nasdaq. The fully correct way to make comparisons across markets would be to use some statistical technique such as matched pairs that attempts to measure spread differences on an "all else equal" basis.

Our second comment relates to the choice of January 2004 as a sample period. Statistics reported pursuant to Rule 11Ac1-5 vary considerably month to month and care must be taken when drawing statistics from a single month to be sure the sample is representative. The January dash-5 statistics for S&P 500 Nasdaq stocks report the second highest average effective spread for all of 2004 released to date.[33]

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elasticity is *b*. Using the same data as was used in the S&P Index Study, we have estimated this elasticity using cross-sectional regression. Estimates are very similar for both Nasdaq and NYSE, averaging around 0.45. To illustrate the meaning of this value, if a stock (on either market) had a price of $20 and an effective spread of 2 cents, the expected spread of a $40 stock for the same order type and size would be about 2.7 cents (= 2 cents × exp(0.45 × log(40/20)). The $20 stock's relative spread would be 10.0 bp, while that of the $40 stock would be 6.8 bp.

[32] There are also compositional differences within the price tiers but for simplicity these are not shown.

[33] The Market Systems Inc. data for February, the month least favorable to Nasdaq, contains clearly erroneous data from ArcaEx. Nasdaq has not identified the source of the error nor do we know if data from the proceeding month, January, is similarly contaminated.

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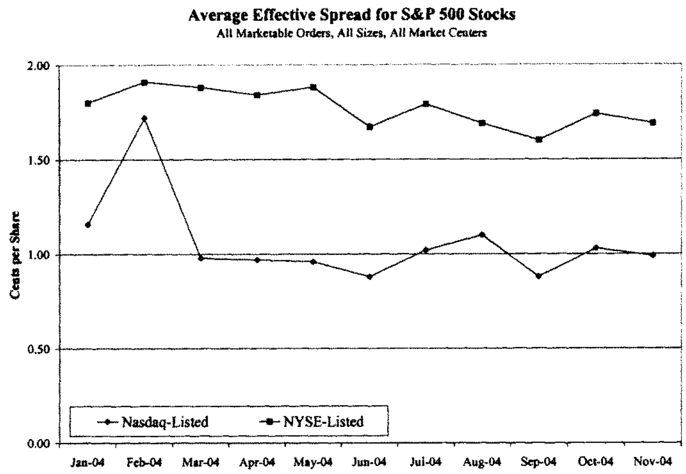

By using a single month, rather than a longer period such as six months as used in the Matched Pairs Study, the S&P Index Study presents results that may not be representative. For example, consider the following table that contains similar data to Table 2 in the S&P Index Study for November 2004 (the most recent dash-5 report month). The results from the Commission's S&P Index Study are completely reversed and the dash-5 data now shows Nasdaq spreads 0.7 bp lower than NYSE spreads rather than 0.2 bp higher.

November 2004 Results

Small Market Orders, S&P 101-500

Effective. Spread (basis points)	
NYSE	NASDAQ
4.4	3.7

Overall in November 2004, Nasdaq spreads, following the S&P Index Study methodology of measuring spreads in basis points without controlling for compositional effects as suggested above, are lower in 8 of 8 order size and type categories for S&P 100 stocks and 6 of 8 order size and type categories for S&P 101-500 stocks. Nasdaq reiterates our earlier conclusion that Nasdaq-listed effective spreads for S&P 500 stocks are significantly narrower than effective spreads for NYSE-listed S&P 500 stocks.

VI. Volatility Study

The Commission's Volatility Study is designed with the stated goal of comparing transitory volatility between Nasdaq- and NYSE-listed securities. To achieve this goal, the study follows the methodology of an NYSE study by comparing the short-term volatility of the national best bid and best ask quote midpoint for 91 stocks that switched from Nasdaq to the NYSE between April 2001 and January 2004. Three questions need to be considered in evaluating the study. First, are the stocks representative? Second, are the statistical measures valid? Finally, is the quote data accurately recorded? We believe that the answer to all three questions is 'no' and that the study is flawed.

Comparing markets through the analysis of securities that switch from one market to the other appears to be a reasonable study design, but pitfalls can exist. Stocks that switch are self-selected. They do not constitute a random sample. One might expect those companies dissatisfied with their stock's recent performance on Nasdaq to be more likely to switch. If this recent performance included above average volatility for reasons completely unrelated to market structure, the study is contaminated. Also, corporate action sometimes coincides with the switch, so that stock characteristics are different before and after. The Volatility Study includes at least one such stock that results in significantly overstating Nasdaq's mean 5-minute volatility. [34] It is also true that specialists are often involved in courting a Nasdaq issue. Therefore, it is not inconceivable that the specialists may take extra precaution with respect to market quality immediately after the switch - knowing they will be closely watched during this period. This effect may wear off with time. Finally, most switchers during the last few years have been smaller companies and not necessarily representative of the stocks most actively traded.

The Volatility Study measures volatility with variance, when it should be measured with standard deviation.[35] It should be noted that NYSE Chief Economist Paul Bennett used standard deviation as the appropriate measure in his study of stocks that switch markets.[36] By using variance, rather than standard deviation, in reporting means and medians, the Commission's study has squared the difference between Nasdaq and NYSE volatility, creating a misrepresentation of relative volatility.[37]

[34] The specific stock in the Volatility Study sample, Cedar Shopping Centers, underwent a 1-6 reverse split and a restructuring coincident with the move. The volatility of this stock declined 99.3% following the move.
[35] Formally, if X is a random variable symmetrically distributed around 0, and $Y = kX$, then Y is unambiguously more volatile than X by a factor of k. The standard deviations of X and Y would differ by this factor, but the variances would differ by a factor of k^2
[36] See Bennett and Wei, 2003, Market Structure, Fragmentation, and Volatility – Evidence from Recent Listings Switchers, NYSE Working Paper.
[37] Volatility Study Table at 2, Figure at 3.

The most troubling aspect with the Volatility Study is that Nasdaq is not able to replicate the results for Nasdaq trading but we are able to replicate the study's results for NYSE trading.[38] While our estimates and those of the Commission's Office of Economic Analysis ("OEA") are within 10% for 40 stocks, OEA's estimates are more than 20% above ours for 40 stocks and more than double ours for 7 stocks.[39] It should be noted that variance estimates are highly sensitive to outliers. Differences between Nasdaq's data and the TAQ data provided by the NYSE and used by OEA could be responsible for the discrepancy.[40] Another potential problem is that the pre-switch data may contain trading in sixteenths for stocks that switched markets close to the time of Nasdaq's decimal conversion whereas all of the post-switch data was in decimals.

The table below presents our results on volatility for five of the return horizons done in the study.[41] To facilitate comparison with the SEC results reproduced in the table, our results are shown as variances. Our results exclude Cedar Shopping Centers, which experienced a significant change in capital structure coincident with the switch.[42] The calculations differ in that we used Nasdaq and SIAC data rather than TAQ and excluded data prior to decimalization. Note that for the five-minute horizon, the SEC variance is approximately three times larger than our variance. The 10-minute SEC variance more than twice our variance.

Comparison of Nasdaq and SEC Results for Nasdaq Volatility
90 Nasdaq-to-NYSE Transfers: April 2001 - January 2004

Time Horizon	Median		Mean	
	Nasdaq	SEC	Nasdaq	SEC
5	0.000559	0.000761	0.000685	0.002063
10	0.000520	0.000692	0.000662	0.001531
15	0.000488	0.000632	0.000645	0.001426
30	0.000456	0.000591	0.000619	0.000995
60	0.000457	0.000588	0.000603	0.001012

In order to provide what Nasdaq believes to be accurate estimates of volatility, reservations with the sample construction not withstanding, the two tables below present Nasdaq estimates of the mean volatility measure appropriately by standard deviation and the mean variance ratio on the two markets around the time of a market switch.

In the first table, we show cross-sectional variation among the volatility results with more active stocks that traded more than 1 million

[38] We thank the Commission's Office of Economic Analysis for their cooperation in trying to resolve this discrepancy.
[39] Email correspondence between OEA staff and Nasdaq Economic Research.
[40] Since Nasdaq quote data is readily available, Nasdaq questions why the NYSE was used as the source of Nasdaq quote data in both the Volatility and Trade-Through Studies.
[41] The Nasdaq sample is 90 stocks because we exclude Cedar Shopping Centers.
[42] Had this stock been included, our mean variance for the 5-minute horizon would have been 0.000827 rather than 0.000685.

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shares per day on Nasdaq showing a much smaller change in volatility than those that traded less than 100,000 shares per day. The average change in standardized 5-minute volatility is from 2.48% to 2.14% or 0.334%. As was noted above, this finding of a change in volatility may be totally unrelated to market structure and the trade-through rule. Other possibilities include natural variation in volatility or the results may reflect cross-subsidization on the part of the NYSE specialist following a switch.

Standard Deviation of Intraday NBBO Midpoint Returns[43]

90 Nasdaq-to-NYSE Transfers: April 2001- January 2004

Avg. Daily Vol. of Stock	5-minute		10-minute		60-minute	
	Nasdaq	NYSE	Nasdaq	NYSE	Nasdaq	NYSE
< 100K Shares (N=24)	2.33%	1.78%	2.25%	1.77%	2.12%	1.78%
100K - 1 MM Shares (N=55)	2.42%	2.11%	2.37%	2.10%	2.23%	2.10%
> 1MM Shares (N=11)	3.16%	3.04%	3.18%	3.02%	3.15%	2.87%
All Stocks	2.48%	2.14%	2.44%	2.13%	2.31%	2.11%

The second table illustrates changes in transitory volatility as measured by variance ratios using the same technique as in Volatility Study Table 2. It should be noted that the level of transitory volatility increases for the more active stocks that switched from Nasdaq to trade on the NYSE.

Average Variance Ratios of Intraday NBBO Midpoint Returns[44]

90 Nasdaq-to-NYSE Transfers: April 2001- January 2004

Avg. Daily Vol. of Stock	5-minute		10-minute	
	Nasdaq	NYSE	Nasdaq	NYSE
< 100K Shares (N=24)	1.29	1.08	1.18	1.04
100K - 1 MM Shares (N=55)	1.20	1.05	1.14	1.03
> 1MM Shares (N=11)	1.04	1.15	1.04	1.13
All Stocks	1.21	1.07	1.14	1.04

[43] Standard deviations have been normalized to reflect daily returns, using the same adjustment as OEA. Specifically, the 5-minute variances are multiplied by (390/5), the 10-minute variances by (390/10), and the 60-minute variances by (390/60), all recognizing the standard trading day has 390 minutes in it.
[44] Variance ratios, following the methodology of the OEA study, are calculated by dividing the indicated short-horizon return variance by the 60-minute return variance. The figures in the table are averages of variance ratios of the stocks in each category, not the ratio of the average variances. Under perfect market efficiency, the variance ratio should be one.

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The goal of the Volatility Study is to determine the effects of illiquidity and transitory volatility for Nasdaq- and NYSE-listed stocks. The study's analysis consisted of measuring the changes in volatility from the Nasdaq environment to the NYSE environment for stocks that switched from one market to the other. Nasdaq was not able to replicate the study's results for Nasdaq-listed trading in certain stocks but was able to do so for NYSE-listed stocks. For some stocks, the differences between Nasdaq's estimates and those of the Commission staff were considerable, over 100%. Nasdaq suggests that the public interest would best be served if Nasdaq and the Commission staff can come to an agreement on the basic facts outlined in the study before any results from the analysis are used in forming a basis for Commission action.

Testimony of Mr. Thomas M. Joyce
CEO and President
Knight Trading Group

Before the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee

Hearing on
"The SEC's Market Structure Proposal: Will It Enhance Competition?"

Tuesday, February 15, 2005

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee, thank you for the opportunity to participate in this important hearing regarding the Securities and Exchange Commission's market structure proposal, Regulation NMS. I commend the Subcommittee for its interest in ensuring that the U.S. capital markets remain competitive and innovative.

Knight Trading Group, through its affiliates, makes markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, and American Stock Exchange, both in the United States and Europe.[1] On active days, Knight executes in excess of one million trades with volume exceeding one billion shares.

[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., and Knight Equity Markets International, Ltd., all of whom are registered broker-dealers. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer, we make markets in nearly all equity securities. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, Knight employs nearly 700 people.

Congress amended the Securities Exchange Act in 1975 to establish the goals of a national market system. Since then the U.S. equity markets have dramatically changed. Rapidly advancing technology continues to improve trading efficiencies and increase competition, all positive developments helping to bring down trading costs for investors. However, for several years Knight has called on the SEC to address several problems in the equity markets, namely the lack of market linkages and efficient access to quotes, the privileged ability of ECNs to charge access fees to non-subscribers, and the negative impact of sub-penny quotations.

Although the SEC, through the re-proposed Regulation NMS (the "Reproposal"), addresses access fees and sub-penny quotations, we have very serious concerns about the SEC's proposal to extend the trade-through rule to all markets. Due to competitive forces and the lack of data supporting such a rule, there is no need to extend the trade-through rule.

The solution is simple: require linkages that efficiently connect all markets and ensure that all displayed quotations can be accessible and executable. This requirement alone could solve many of the market structure problems faced today. If there are efficient linkages, then the need for a trade-through rule on any market is greatly diminished, if not eliminated. Rules should be put in place to benefit investors and the markets. However, the best way to benefit investors is not by imposing a trade-through rule, but to instead require linkages so investors' trades can receive best execution.

Additional regulation should not be imposed simply for the sake of regulation. There must be a clear and unambiguous purpose for additional laws or regulations, and they must have

a material and demonstrable positive impact upon investors. We respectfully submit that no such purpose and no such benefit has been articulated which would justify the massive restructuring of the U.S. capital markets called for by the proposed trade-through rule.

There is no evidence to support extension of the trade-through rule. Many market constituencies do not believe that an extension of the trade-through rule is needed. In justifying a trade-through rule, the Commission referenced its data suggesting that 7.9% of the volume, or about 2.5% of trades executed on the Nasdaq (which currently has no trade-through rule) are traded-through. This compares with 7.2% of the volume, or about 2.5% of trades executed on the New York Stock Exchange, which does have a trade-through rule. The SEC's data on trade-through rates is nearly the same for a market that currently has a trade-through rule and one that does not, so it is unclear what is to be gained by instituting a trade-through rule across all markets. This suggests that the stated benefits to a trade-through rule may prove to be highly elusive.

In addition, as with any far reaching regulation, it may result in serious unintended consequences. Government mandated paths of trading could have a substantial negative impact on the technological innovations that have served to benefit greatly the U.S. investor over the last decade. Indeed, the technology timeline has been so compressed, that we are now experiencing technological innovations in the market almost daily.

The driver of this innovation can be summed up in a single word: "competition." Nowhere is competition greater and fiercer than in the securities markets. Profit margins have

been cut to razor thin levels, and technological advancements are staggering. Today, the typical U.S. investor experience can best be described as: ***blinding speed at the best price.*** By forcing all trades to take a similar route and be handled in a similar manner, we will undermine the very foundation of competition – that is, ***the distinctions in execution offerings that motivate the investor.***

Indeed it is those very distinctions which, in turn, drive the markets to improve. If every investor wanted a trade handled in exactly the same manner, then we could simply centralize the markets and create a labyrinth-type utility for trade executions. However, the U.S. investor would never stand for that. They want fast trades, complete fills, minimal impact, superior pricing, minimal costs, and the list goes on. These investor demands move the markets to create, innovate, and operate in a highly efficient manner. Too many unnecessary rules create hurdles and roadblocks, and take competition away. As a consequence, market innovation may be stymied to such an extent that the investor experience ceases to improve and, worse yet, degrades.

In the Reproposal, the SEC makes a preliminary determination that a trade-through rule would encourage the posting of limit orders. We do not believe this to be the case. In fact, we firmly believe that many investors will not want to grant "free options" on their orders by placing additional limit orders of size in the market. If an investor wants to buy 10,000 shares of a security, he is not likely to want that openly displayed. In a decimal environment with compressed spreads at a penny, orders can simply step in front of him for one cent and receive execution priority. Rather, he prefers anonymity, and looks for his order to be worked into the

market, creating as little impact and volatility as possible. Thus, since we do not believe the Commission's data supports the need for any trade-through rule, we firmly believe that ***neither*** of the two alternative trade-through rules – Market BBO alternative (also referred to as "top-of-book") and voluntary display alternative (also referred to as "depth-of-book") – are warranted.

The Reproposal significantly underestimates the costs of instituting a trade-through rule for all markets. No trade-through rule has ever existed in the Nasdaq market, so firms like Knight will face a significant technology cost burden. They will be required to adjust their trading system technology, as well as develop compliance systems and add personnel, to monitor compliance with the rules. The costs of these technology and personnel changes will be significant, yet the benefits of a trade-through rule are minimal. The costs to the investor will be great, as investors will inevitably suffer from reduced market efficiencies brought about by a centralized, mandated trading protocol – which looks to handle all orders, regardless of size or investor preferences, in exactly the same manner.

The technology costs would include expenses relating to what we expect to be an exponential increase in message traffic due in part to chasing quotes in stocks where prices are flickering. Most trade-throughs occur at one penny, which the Commission has already indicated would be acceptable for stocks, such as Exchange Traded Funds ("ETFs"), with flickering quotes. In particular, the depth of book alternative, or what is sometimes referred to as a virtual Central Limit Order Book ("CLOB"), would impose the greatest technology costs as message traffic would increase even more.

<u>Competition, rather than regulatory mandates, should drive market participants.</u>

Unlike a trade-through rule mandate, the SEC's Rule 11Ac1-5 ("Rule 5") is a shining example of regulation that increases competition by promoting transparency and comparability. The rule requires market participants to post their execution statistics in accordance with standardized reporting metrics. As a result, Rule 5 has provided transparency and comparability of execution statistics, which order routing firms can and do use to make more informed routing decisions to meet their clients' needs. This has increased competition and pressured markets to continue to improve the execution of customer orders, as well as dramatically reduce costs for investors. An individual can now pay brokerage fees as low as about $5 per trade, while only a little over a year ago $15 trades were on the low end of the cost scale. Only a few short years ago, a 60-second execution in a Nasdaq-100 stock was considered a good execution. Today, most marketable executions are measured in sub-second increments. We believe this is due to competitive forces, not regulatory fiat.

We do not know what future, technological innovations are on the horizon. However, we do know for certain that those innovations and increased efficiencies may never come to fruition if we do not encourage and foster a competitive market environment, ***rather than*** pursuing and expanding antiquated, command and control methods of trading. A regulatory approach such as Rule 5, based upon the principle of promoting competition through full disclosure (as opposed to mandated paths of trading), provides a far less invasive and less costly way to achieve the goals of a trade-through rule.

There is no evidence to suggest that a trade-through rule will increase limit orders. As noted above, we do not believe that a trade-through rule would encourage the posting of large limit orders. In addition, we do not believe that small investors would benefit by a trade-through rule. In a penny trading environment, there is little incentive to post limit orders. In fact, Charles Schwab data indicates that its customers "tend to use limit orders approximately twice as often for Nasdaq-listed stocks… as for exchange-listed stocks."[2] If a trade-through rule is to encourage limit orders, it will not accomplish that goal since retail investors appear to use limit orders on Nasdaq-listed stocks (with no trade-through rule) much more often than on exchange-listed stocks (with a trade-through rule). We believe that the typical U.S. retail investor prefers the use of market orders, as opposed to limit orders, as it provides them the opportunity to immediately gain access to the displayed price and size they see in the market. For example, another large retail brokerage firm, Ameritrade, noted the results of a Gallup Organization poll which showed evidence that investors want the price they are quoted and they want fast execution of their trades.[3]

Indeed, we believe that limit orders tend to be used more frequently by professional traders. They use oversized limit orders to probe for undisplayed liquidity, knowing full well their order will only be partially completed. In fact, we believe that this trading strategy contributed to the "unfulfilled" limit order rate referenced in the SEC Staff study. Thus, it is not the typical investor order which is not being filled, rather the professional arbitrageur who is fishing for orders. If it were the U.S. investor order being unfulfilled, you could rest assured that

[2] *See* letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, February 1, 2005, at 3.
[3] *See*, letter from John S. Markle, Associate General Counsel, Ameritrade Holding Corporation, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, October 13, 2004, attachment.

investors would be screaming for their brokers to advocate for a trade-through rule. Indeed, we have seen the exact opposite. Large retail-based brokers (such as Ameritrade and Charles Schwab) have argued that there is absolutely no need to extend the rule at all, particularly into Nasdaq.

In short, investors will not benefit from an extension of the trade-through rule to Nasdaq. Instead, investors have benefited by lower trading costs which are the result of increased competition and innovation. Extending the trade-through rule would inhibit further innovations and competition – the very factors that have driven costs dramatically lower over recent years.

Rather than imposing a trade-through rule at this time, a phased approach to addressing market structure issues should be implemented. Mandating effective connectivity and access between markets and participants, including elimination of access fees and sub-penny quotations, would be the necessary first step or phase to address most of the current market inefficiencies. Although it addresses access fees and sub-penny quotations, the Reproposal does not adequately address the need for improved connectivity to ensure that all markets are linked and can be accessed immediately.

Requiring connectivity would go a long ways toward ensuring that investors receive best execution of their orders. Non-automated markets force an automated market to wait for execution and deal with inaccessible quotes. The inability to automatically access displayed liquidity may also place brokers unfairly at risk for best execution liability when they are unable to obtain a better price for a customer because that price was inaccessible. Requiring

connectivity and access would address these market inefficiencies. Once connectivity and access are established, the Commission would be in a better position to examine data and determine whether there is a need for further investor protection rules or best execution guidance. If necessary, a pilot program covering select stocks could then be implemented to examine the impact of imposing a trade-through rule on those stocks.

Knight supports the Commission's proposals relating to limiting access fees, banning sub-penny quotations, and locked and crossed markets. Knight still believes that all non-subscriber access fees should be eliminated in order to establish integrity of the quote and to address the market distortions such fees cause. ECN access fees and rebates provide an economic incentive of certain market participants to lock and cross, which can lead to confusion in the marketplace. If the SEC chooses not to abolish access fees, Knight supports efforts to limit access fees to minimize these impacts.

Knight also continues to support a ban on sub-penny quotations. Sub-penny quotations diminish liquidity at each price point and make it easy for professionals to jump ahead of limit orders. In addition, Knight supports the adoption of a rule prohibiting locking the quotation of an automated market.

Conclusion. Knight reiterates its view that competition fosters innovation and efficiencies, ultimately benefiting the markets and investors. Connected markets and efficient and fair access will do more to benefit investors than a costly, unproven command and control trade-through rule. Knight recommends that the SEC minimize unintended consequences by

taking a market oriented approach that requires connectivity, efficient and fair access, and later considers whether a trade-through rule is necessary.

I greatly appreciate the Subcommittee's interest in examining the issues relating to Regulation NMS. Thank you for the opportunity to contribute to this important dialogue.

Written Testimony of
Robert H. McCooey, Jr.
President and Chief Executive Officer
The Griswold Company, Incorporated
Member, New York Stock Exchange

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Hearing on
"The SEC's Market Structure Proposal: Will It Enhance Competition"

February 15, 2005

Testimony of Robert H. McCooey, Jr. Member of the New York Stock Exchange and Chief Executive Officer of The Griswold Company, Incorporated

February 15, 2005

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is Robert McCooey. I am a proud Member of the New York Stock Exchange and President and Chief Executive Officer of a New York Stock Exchange member firm, The Griswold Company, Incorporated. Griswold is an agency broker executing orders for institutional clients on the Floor of the NYSE. As an agency broker, we execute trades on behalf of our customers. We do not make markets in securities or engage in proprietary trading. Our clients include some of the largest mutual and pension funds in the United States.

Thank you for inviting me here today to testify concerning the SEC's Regulation NMS market structure proposal. I will focus my comments on the trade-through rule section of the proposal, where the SEC offered two alternatives. The first, called the Market BBO (or best bid and offer) Alternative, would be a modification and a modernization of today's trade-through rule to account for the speed of execution in today's market. The second, called the Voluntary Depth Alternative, is a major expansion of the order routing demands of the current trade through rule. I applaud the SEC's work in coming up with these alternatives and will comment more extensively on each.

When I last had the privilege of testifying before this committee last year at about this time in New York, the debate had just begun about whether or not to have a trade-through rule in the National Market System. Today, with the latest SEC Regulation NMS proposal, the debate seems to have shifted from whether or not to have a trade-through rule to what form a trade-through rule should take. I am pleased that the SEC has recognized the importance of maintaining some form of a trade-through rule in the National Market System. As we comment today on how this trade-through

rule should work, we must make sure that it allows for competition between the various market models in the National Market System for the benefit of all investors.

As an agent on the Floor of the NYSE for the past 17 years, I have seen the evolution of Floor brokers from providing outsourced executions for the major broker-dealer firms to establishing themselves as strategic partners for institutional clients. Increasingly, the goal for clients has been to find ways to gain efficiencies in the execution process by getting closer to the point of sale. Independent agents working on behalf of these customers now furnish real-time market information coupled with tremendous cost savings to these institutional customers. The assets that are managed by my institutional customers are owned by the small retail customer: the pensioner, the parent saving for college, the worker funding his or her IRA and all the others who invest in equities traded here in America. Today in the United States, when we talk about doing what is right for the marketplace and the participants in that market, we must realize that the retail customer and the institutional customer are one and the same. Institutional customers simply represent the commingled interests of many retail investors.

Floor brokers play an important role in the price discovery process. The competition between orders represented by brokers at the point of sale on the Floor of the NYSE helps to ensure fair, orderly and liquid markets. It is the Floor broker who will seek out contra side liquidity for an order as well as make decisions based upon rapidly changing market dynamics. The Floor broker serves as a point of accountability and information, with the flexibility to represent large orders over time at the point of sale – not found in dealer markets and ECNs – and employs the most advanced technology to support his or her professional judgment. The interaction between the Floor broker and the specialist provides the flow of information necessary to keep customers informed about changing market conditions. That information flow is more often than not the catalyst that provides incentives for traders to provide liquidity in a way that reduces execution costs. The combination of best price and intelligent information flow is the backbone of the NYSE.

Superior technology will continue to be the NYSE's advantage. During the past decade, the NYSE has invested billions of dollars in technology for our Trading Floor, data centers, and new product and service development. The NYSE Floor has one of the largest deployments of flat

screen technology anywhere in the world. Brokers no longer write on little slips of paper and have "pages" transport the information from point-of-sale to a phone clerk for relay to our clients. The agent relies upon a digital handheld communication device, which receives the order, transmits the reports (often directly to the customer) and engages in an ongoing dialogue with the client through the use of digital images. All of this is accomplished without ever leaving the trading crowd. In the future, as the NYSE implements its hybrid market, the technology at the disposal of the floor broker will further increase.

Evolution of the Trade-Through Rule Debate

De-Miminis Exception

The debate over the trade-through rule has evolved greatly over the last couple of years. At first, there was discussion of expanding to listed securities the de minimis exception currently in place for ETFs. However, such an exception runs contrary to the whole principle of decimalization and moving to a minimum price variation of a penny. If Congress and the SEC were trying to save investors money by going to penny pricing, why would they turn around and say that pennies do not matter by issuing a de minimis exception?

Arguments were made at that time about the tremendous savings to investors from the shift to decimal pricing of securities. If a fund foregoes better available and accessible prices for the sake of speed, the negative cost impact to the fund's shareholders is in the millions of dollars. For a fund trading an average of ten million shares a day (not unusual today), to receive that incremental penny of price improvement on all those shares and multiplied by 250 trading days in a year, the savings are twenty-five million dollars ($25,000,000), which rightfully belongs to your constituents, the investors in that fund. Furthermore, I am only giving you one example of just one fund manager. Across thousands of funds and billions of shares traded, the potential negative impact to investors makes the term "de minimis" a real misnomer.

Fortunately for investors, no such exception has been created.

Fast Quote / Slow Quote Exception

Then there was discussion of providing an exception from the trade-through rule for slow quotes or quotes that were not accessible electronically. The main premise for this debate was centered around the fact that the even though the NYSE had the best price 93% of the time and price improvement 29% of the time, other markets could not access those prices because of the 10-15 seconds on average that it took for an order to be executed on the Floor of the NYSE. Opponents of the trade-through rule argued that the NYSE's "best prices" were only "advertised" prices because in the 10-15 seconds that it took for an order to get executed the market could have moved 2-3 cents or more.

To his credit, NYSE CEO John Thain recognized the validity of this argument not only from a public policy perspective but also from a business perspective. Collectively the members of the NYSE agreed that if the NYSE did not provide its customers with the speed of execution that they desired, they would consider taking their business to another market. So, Mr. Thain proposed to expand the automatic execution offering at the Exchange without sacrificing the advantages of best prices and low volatility associated with the manual auction market. The NYSE's Hybrid Market proposal, which is still at the SEC awaiting approval, will offer customers the best of both worlds. The auction market will remain, but customers who want the speed and certainty of execution associated with automatic execution will now have that option as well. Many longtime critics of the NYSE have applauded the goals of the Hybrid Market and are looking forward to its implementation.

At the same time, the SEC also recognized that forcing electronic markets to chase after better "advertised" prices on manual markets was neither practical nor advantageous to the investor, especially since the price could change for the worse in the time it took to get a execution on the manual market. As a result, the SEC proposed a fast quote/slow quote exception from the trade through rule. Essentially, the reproposed rule states that if a superior quote on a market is not accessible electronically, another market with an inferior quote can trade through the superior quote. This exception recognizes the fact that speed should be a factor in determining the best execution for the investor.

The fast quote/slow quote exception is a significant and sensible change to the trade-through rule, and is the basis for the SEC's Market BBO Alternative, which I will discuss further.

Opt-Out

The SEC also initially proposed an opt-out provision for "informed investors." Opponents of the trade through rule argued strongly for this option. They said that speed and other factors could be just as important if not more important than price and that an "informed investor" (i.e., institutional investors) would know when this was the case.

I opposed the opt out because it ran contrary to the principle of best price for the investor and rewarding the best displayed price with an execution. I supported, and continue to support, a fast quote/slow quote exception because while it recognizes speed as an important factor, it is only important in so far as it affects best price or one's ability to access the best price. Speed of execution is not more important than price; rather it is a factor in determining price. However, the opt-out would have allowed speed, regardless of its effect on price, to be the sole reason for executing on a particular market. There is no sound public policy rationale for this. Also, there were practical issues concerning who could opt out for whom and how often. For example, did a mutual fund manager have the right to opt out on behalf of his millions of investors, or would he have to get affirmative approval from each investor? I, for one, would certainly want to know if my fund manager was opting out of the best price for a faster trade with my money.

Fortunately, neither of the SEC's latest alternatives includes such an opt out. I believe that this is the best decision for investor protection.

SEC's Current Trade Through Rule Alternatives

Market BBO Alternative

Of the two alternatives currently pending before the SEC, I strongly favor the Market BBO Alternative over the Voluntary Depth Alternative. The Market BBO Alternative is the result of thorough debate and comment over the last year at the SEC. It modernizes the trade through rule in a way that recognizes the speed of today's fast moving markets without sacrificing

the principle of best price protection for the investor. I am especially pleased that it does not include either a de minimis exception or an opt out provision. As I discussed above, the fast quote/slow quote exception, which is the basis of the Market BBO Alternative, is the right approach, and appropriately resolves the issue of best "advertised" quotes.

Equally important, the Market BBO Alternative provides the proper incentives for both intramarket order competition and intermarket order competition. Within each market, each participant is rewarded for having the BBO for that particular market. There is also sufficient order flow incentive for markets to produce the best prices in the National Market System. This is a delicate balance but it is essential for continued growth and innovation by markets.

Voluntary Depth Alternative

On the other hand, I strongly oppose the Voluntary Depth Alternative as proposed by the SEC. This is a radical proposal that could do irrevocable harm to the National Market System.

Although the SEC calls it voluntary, it is not voluntary at all. The SEC says that for those markets that display their books, those displayed orders, through the entire depth of the book, would be protected. While this is voluntary on the part of the market displaying the order, other markets are compelled to honor those quotes. Also, as a practical matter, if one market displays its book, other markets will need to display their books to ensure that they receive similar quote protection for their depth of book.

Furthermore, the Voluntary Depth Alternative picks winners and losers. A market that is not an all-electronic market would have no role in the Voluntary Depth Alternative world. If a quote is not displayed and electronically accessible, it has no protection. What happens to the liquidity on the reserve book that is not displayed? What happens to the auction side of the NYSE's Hybrid Market? Regulation NMS should not pick winners and losers. Instead, it should lay down principles that will allow different market models to compete within the National Market System.

Many commentators have commented that this alternative would behave like a CLOB, and I agree with them. The Voluntary Depth Alternative would homogenize markets and remove all incentives for

intermarket competition. It would also require the mandatory routing of orders between markets. I can support routing orders between markets at the top of the book because it provides incentives for participants to post the best prices within markets while maintaining the incentives for each market to have the best price compared to other markets. However, I cannot support mandatory order routing for the depth of book. The most troubling part of the proposal is the consequence of shifting the best execution obligation from the broker dealers (where it belongs) to market centers. The first market will now determine where, how and when orders are shipped to access liquidity in another market. That is my responsibility as a broker on behalf of the customer who has entrusted me with the order. Furthermore, who will take the blame – economic or otherwise – for a missed market or bad fill because a particular market's order routing algorithm sent an order to the wrong market center?

Also, the Voluntary Depth Alternative would greatly reduce liquidity in the market. In the trading world, everyone wants to know what everyone else is doing without telling anyone what they are doing. The reason institutions hire me to do a trade is so that I can move a large amount of stock in a manner that gets the best execution possible with as much anonymity for them as possible. If we move to a world where only displayed quotes get executed, the institutions are going to execute their trades outside of the National Market System. They may even go to Europe. There is a role for the displayed quote, but there is also a role for the broker in an auction market and the reserve book in an electronic market.

It is my hope that the SEC will act soon to reject the Voluntary Depth Alternative and approve the Market BBO Alternative. It is the result that will best protect the interests of the nation's investors. It is also the result that will preserve the forces of competition and innovation that have thus far kept the U.S. capital markets at the forefront of global competition in the financial services sector.

Thank you. I look forward to answering your questions.

Testimony of

Mr. Edward J. Nicoll
Chief Executive Officer, Instinet Group Incorporated

U.S. House Subcommittee on Capitol Markets, Insurance and Government Sponsored Entities

February 15, 2005

Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, thank you for inviting me to appear today to discuss the SEC's reproposed version of Regulation NMS. This subcommittee has held hearings throughout the formulation of the proposed rule, and I greatly appreciate the time and effort you have taken to understand the complexity of the issue and to remain involved in the process. In particular, I want to thank you, Chairman Baker, for your leadership on this issue.

Today, thanks to your interest and hearings like this one, almost everyone agrees that the old rules need to be reformed in order to promote greater competition. As SEC Chairman William Donaldson said last December, "the existing trade-through rule is not working as intended." Even such fierce rivals as the NYSE, Instinet and NASDAQ are now debating what reform is needed, not if reform is needed: a much healthier debate.

This afternoon, I would like to spend a few minutes reviewing Instinet's position on the portion of Regulation NMS that has been receiving the most attention – the issue of the trade-through rule.

When the SEC reproposed Reg NMS last December, Commissioner Cynthia Glassman encouraged those submitting comments not just to consider what type of trade-through rule they preferred, but if any trade-through rule is even necessary. We have taken Commissioner Glassman's words to heart and continue to advocate for the elimination of the trade through rule. Its repeal would foster competition without favoring one market model or another.

I must say that I was surprised by elements of the reproposed rule, since even at this late point in the process the case for retaining any trade-through has not been made. Sure, that case has been made rhetorically over and over by the NYSE and

its allies. But today, most of us are understandably skeptical of the arguments put forward by any business that actually lobbies for MORE government regulation. We have rightly learned to discount such lofty rhetoric unless it is accompanied by facts. Sound economic principles, solid data and real world experience must be our guides when implementing rules that will impact our nation's capital markets, not rhetoric. Let's look at whether the trade-through debate can survive an analysis based on facts.

There are two main arguments that are used to support the trade-through rule.

First, it is said that a rule is necessary to protect investors from unscrupulous brokers that may execute customer orders at inferior prices. However, when the SEC proposed an opt-out provision so that those who did not believe that they were being taken advantage of could waive the unwanted protection in exchange for greater flexibility and control over their order, there was an uproar of opposition from the defenders of the status quo. Once it became apparent that the inclusion of an opt-out provision could have addressed the stated concerns of both sides – by protecting small investors but giving flexibility to sophisticated investors – the advocates of regulation had to shift to a second rationale for preserving the rule.

The second defense of the trade-through rule is that it encourages limit orders. The simple example given by supporters is one of the virtuous retail investor that bravely posts a limit order only to watch in dismay as other markets trade at prices inferior to the retail investor's price. All of this causes the retail investor to lose confidence in the market and to stop posting limit orders. With fewer limit orders, spreads widen and market quality is compromised. It's a good story but with a significant flaw: there is no empirical evidence to show that it's true. Moreover, the absence of a trade-through rule in other markets has not resulted in such a loss of confidence. In fact, retail investors have shown a preference for placing limit orders on the NASDAQ – without any so-called "trade-through protection" – over the NYSE.

I am concerned that the SEC has adopted the position that the trade-through rule promotes limit orders based on research that, upon closer examination, seems to prove just the opposite. In a study by the SEC's own Office of Economic Analysis, the SEC examined just 4 days of trading in 2003. The entire reform that has been debated for years is based on just 4 days of empirical evidence. And what did it find? The trade through rate for NASDAQ-listed securities was just 2.5% of trades – and a mere 1.9% of volume when limited to displayed size. This finding

can only mean that supporters of the trade through rule believe that even though more than 97.5% of the time a limit order is not traded through, the mere 2.5% risk of being traded through is enough to discourage limit orders.

I don't believe that this extremely small risk deters limit orders. In fact, some of the largest brokerage firms that represent individual investors – including Schwab, Ameritrade, Morgan Stanley, Scottrade and even Goldman Sachs – report that they receive more limit orders for NASDAQ stocks – where there is no trade-through rule – than for NYSE stocks, where one presently exists. Further, the SEC's own study also noted that there were more limit orders placed in NASDAQ stocks than NYSE stocks. So how can there be more limit orders in NASDAQ stocks than NYSE stocks when NASDAQ does not have a trade-through rule? I believe it is because there is full confidence in the marketplace as well as a competitive and innovative environment that has provided investors with the choices and flexibility they demand when investing in a modern market.

So based on its own internal numbers, shouldn't the SEC be proposing the elimination of the rule entirely – as Commissioner Glassman suggests? Unfortunately, the SEC instead has indicated that it will impose the regulation on both the NASDAQ and the NYSE and has only asked for public comment on its two ways to apply this expanded trade-through rule: top of book and voluntary depth of book.

We believe that this is a false choice. Neither is a step forward for individual or institutional investors. The top of book proposal is largely the existing rule, with some modernization, extended to the NASDAQ marketplace. It would retain all of the problems created by a trade-through rule – still limiting investor choice and competition between markets – without protecting the majority of limit orders. That's why I believe that if the trade-through rule is retained and even expanded to the NASDAQ using the justification that we must protect limit orders, all limit orders should be protected under the voluntary depth of book proposal.

Defenders of the trade-through rule have, in effect, been hoisted on their own petard. The NYSE circulated a letter from the Consumer Federation of America last summer defending the trade-through rule but the CFA's latest letter takes the logical next step and calls for adoption of the voluntary depth of book alternative. I do not see that letter with the NYSE's material today. After arguing for years that the rule is necessary to protect investors, they are now backtracking to oppose the logical conclusion of the argument – that the rule should be applied to all orders and not just a lucky few.

This difference of opinion is not surprising. In fact, public comment letters to the SEC make it clear that there are sharp divisions on this issue. The NYSE and some others are strong defenders of the regulation. Yet 37 Members of the House and Senate signed comment letters last year calling for the repeal of the trade-through rule or, at the minimum, the inclusion of an "opt-out" provision. They were joined by nearly a dozen statewide officials from coast to coast, ranging from California Controller Steve Westly to Florida Attorney General Charlie Crist. Also calling for repeal or opt-out were more than a dozen state pension funds and labor unions, including some of the largest like the California and Ohio Public Employees Retirement Systems, the Teachers' Retirement Systems of Louisiana, Indiana and California, and The College Retirement Equities Fund and its companion organization the Teachers Insurance and Annuity Association of America (collectively known as TIAA-CREF). Major financial institutions such as UBS, Morgan Stanley, JP Morgan, Merrill Lynch and Citigroup joined retail firms like Ameritrade, Fidelity and Schwab as they all called for the rule's repeal or an opt-out exception.

Nor is there consensus on the top of book or depth of book proposal. The Securities Traders Association calls for a phased approach that is completely different from the SEC's proposal while a diverse group that includes the Investment Company Institute, the Consumer Federation of America and Instinet Group all prefer the voluntary depth of book proposal if the trade-through rule is retained as currently proposed. The other side has its champions, too. But it is clear that there is no clear consensus for <u>any</u> of the proposals the SEC is currently considering.

Such sharp divisions should be taken very seriously. We are considering fundamental changes in how our markets operate and compete. While we should not expect full consensus across our industry, I would think the SEC would be wary of sweeping changes with their related costs to investors in the face of such a deep split and with so many questions still unanswered.

Keeping in mind these unanswered questions, let me summarize the key remaining issues and Instinet Group's position.

First: the trade-through rule is an unnecessary burden that hinders competition, ultimately harming rather than protecting investors.

Second: on no account should the trade-through rule be extended to the NASDAQ marketplace. The NASDAQ market is an example of a highly liquid and highly competitive market where the competition has reduced investor costs, narrowed spreads and improved performance for all investors.

Again, let me be perfectly clear on this point. Neither independent nor SEC research demonstrates the need for the trade-through rule on the NASDAQ marketplace. As Chairman Donaldson himself said when reproposing Reg NMS, "We ought not lose sight of the fact that the U.S. equity markets today work pretty well both for investors and for issuers. Spreads are thin. Volatility is manageable. There is no need for radical surgery in pursuit of a Platonic ideal." He went on to say, "We need to identify real problems, consider the practical consequences of the possible solutions, and then move pragmatically and incrementally towards the goals Congress staked out."

Applying the trade-through rule to the NASDAQ marketplace is not a pragmatic and incremental move. It should be taken only when it is clear that the market is failing and less drastic remedies are inadequate. As Hippocrites admonished millennia ago, "First, do no harm."

And Third: if the SEC still feels the overwhelming need to protect limit orders by strengthening the trade-through rule and imposing it on the NASDAQ marketplace, it should implement a consistent rule that protects all limit orders through its voluntary depth of book proposal and not one that only protects the lucky few. It is simply not logical to impose a rule to protect a few and leave the rest to fend for themselves.

I've commented in greater technical detail on our position in the documents accompanying my remarks today and ask they be included in the record.

In conclusion, Mr. Chairman, this is all about how consumers can get the greatest return on their investments for the lowest cost. Regulatory reforms in NASDAQ have fostered competition, lowered trading costs, and delivered tremendous value to all investors – and without a trade-through rule. In the absence of clear evidence of its value, the trade-through rule, or "ossified relic" as some have called it, should finally be retired.

I thank you for your time and effort and would happily answer any questions you might have.

INSTINET GROUP

January 26, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: **Reproposal of Regulation NMS, Securities Exchange Act Release No. 50870 (File No. S7-10-04)**

Dear Mr. Katz,

Introduction

Instinet Group Incorporated ("Instinet Group") appreciates the opportunity to provide the U.S. Securities and Exchange Commission ("SEC" or "Commission") with its comments on the recently reproposed Regulation NMS ("Reproposal").[1] Instinet Group, through affiliates, is the largest global electronic agency securities broker and has been providing investors with electronic trading solutions and execution services for more than thirty-five years. We operate our two main businesses through Instinet, LLC,[2] and Inet ATS, Inc. ("INET").[3]

On June 30, 2004, Instinet Group submitted a comment letter setting forth its views on the initial Regulation NMS proposal and the issues raised in the Supplemental Request for Comment.[4] Where applicable, this letter incorporates by reference the views contained in our Initial Comment Letter.

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[1] Exchange Act Rel. No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Reproposing Release"). The SEC originally proposed Regulation NMS in Exchange Act Rel. No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Proposing Release") and subsequently requested further comment on certain aspects of the proposal in Exchange Act Rel. No. 49749 (May 21, 2004), 69 FR 30141 (May 26, 2004) ("Supplemental Request for Comment").

[2] Instinet, the Unconflicted Institutional Broker, gives its customers the opportunity to use its sales-trading expertise and advanced technology tools to interact with global securities markets, improve trading and investment performance and lower overall trading costs. Instinet acts solely as an agent for its customers, including institutional investors, such as mutual funds, pension funds, insurance companies and hedge funds. Additional information regarding Instinet, LLC can be found at http://www.instinet.com.

[3] INET, the electronic marketplace, provides its U.S. broker-dealer customers one of the most robust liquidity pools in Nasdaq equities, substantial liquidity in U.S. exchange-listed securities, and routing access to other major U.S. trading venues. Additional information regarding INET can be found at http://www.inetats.com.

[4] See Letter from Edward J. Nicoll, CEO, Instinet Group, to Jonathan G. Katz, Secretary, SEC, dated June 30, 2004 ("Initial Comment Letter").

Executive Summary

Reproposed Trade-Through Rule

- Instinet Group does not believe that a strict trade-through rule such as that proposed by the Commission is in the best interests of investors or the markets.
- We believe our position is strongly supported by the most relevant data on trade-throughs provided by the Commission's Office of Economic Analysis, which show that trade-throughs only account for 2.5% of trades and 1.9% of volume in Nasdaq stocks, where no trade-through rule is currently in place, and 2.5% of trades and 1.2% of volume in NYSE stocks, where the much-criticized ITS trade-through rule prevails.
- The Commission has not only failed to demonstrate that there is any paucity of limit orders in the U.S. equities markets (its original justification for a trade-through rule), but its very own data makes clear that investors are not withholding limit orders from the market because they may be traded through.
- If the Commission nonetheless determines to adopt its reproposed trade-through rule, however, we believe that the Commission should limit the scope of the rule to the trading of NYSE-listed stocks. Given the existing high degree of market quality, robust competition and innovation, and low incidence of actual trade-throughs exhibited on the Nasdaq market in the absence of a trade-through rule, we can discern no legitimate justification for extending the rule to the trading of Nasdaq-listed stocks.
- We see no legitimate policy or practical justification for limiting the scope of protected quotes under the reproposed rule by adopting the Market BBO Alternative instead of the Voluntary Depth Alternative. Once the policy determination is made that limit orders should be protected by force of rule, the only logically consistent course of action is to protect as many limit orders as possible. We anticipate little difference in the costs to market participants and the damage to intermarket competition associated with a trade-through rule limited to top of book as compared to one that extends to depth of book. These costs and burdens overwhelmingly come from the imposition of a trade-through itself, not the scope of the rule.

Reproposed Maximum Cap on Market Access Fees

- Instinet Group reiterates its strongly held belief that the Commission should not adopt any cap on the maximum access fees that may be charged by broker-dealers and SROs, as such restrictions do not advance investor protection and impair Congress's goals for the NMS. The ability to charge transaction fees at prices determined by the market, not government fiat, is central to the ability of markets, particularly agency markets, to exist and enable investors to benefit from the valuable services they provide.
- If the Commission determines to proceed with the adoption of a maximum cap on market access fees, however, Instinet Group believes that any such cap should be

limited to a single accumulated fee limitation and set at no less than the current $0.003 per share level, as provided for in the Reproposal. In addition, Instinet Group believes that the Reproposal does improve upon the original proposal by addressing its unnecessary discrimination against market participants entering unattributed orders, reducing the potential for unintended consequences, and simplifying the administration of any final rule.

Reproposed Restrictions on Locked and Crossed Markets

- Instinet Group strongly opposes the adoption of the reproposed rule restricting locked and crossed markets in NMS stocks as contrary to the interests of investors and the markets. Restricting locked and crossed markets impairs market transparency and efficiency, artificially widens spreads, and discourages investors from entering aggressively priced limit orders. We believe that enabling market participants to lock or cross manual quotations will do little to mitigate the negative impact the reproposed restrictions will have on market efficiency and transparency.

Reproposed Market Access Requirement

- Instinet Group believes that there is a strong public policy interest in ensuring that market participants have the ability to access, on reasonable and non-discriminatory terms, all publicly displayed interest in the NMS. Prior to taking any action on the Reproposal, however, Instinet reiterates its request that the Commission should clarify the meaning and proposed application of its "unfairly discriminatory" standard.

Reproposed Revision to Volume Threshold for the Application of the Regulation ATS Fair Access Requirement

- Instinet Group supports the adoption of the reproposed reduction of the volume threshold for the application of the fair access requirement of Regulation ATS to a particular security from 20 percent to five percent. Reducing the volume threshold would ensure equal regulation of, and a level competitive playing field among, all ATSs that are significant market centers in the NMS.

Reproposed Restriction on Subpenny Quotations

- Instinet Group opposes the adoption of the proposed restrictions on subpenny quotations. Market forces, rather than government intervention, should determine the appropriate trading increment for a security. Market forces already have shown their responsiveness, largely limit subpenny quoting to securities priced under $1.00, with the exception of a small number of high volume securities with active subpenny markets.

- If the Commission nevertheless decides to adopt a restriction on subpenny quoting, at a minimum, it should provide a specific exception for the Nasdaq-100 Index ("QQQQ") and certain other securities with demonstrated active subpenny markets. The Commission also should further facilitate the process of obtaining exemptive relief from the prohibition.

Reproposed Revisions to NMS Plan Market Data Revenue Allocation Formulas

- Instinet Group opposes the adoption of the reproposed market data revenue allocation formula. The proposed formula fails to provide any appreciable benefits for investors or advance Congress's goals for the NMS. The reproposed formula makes arbitrary judgments as to the value of market information that inevitably will produce significant gaming behavior, market distortions, and other, as yet unknown, unintended consequences.
- Instinet Group continues to believe that a more appropriate course of action for the Commission would be to consider discrete measures to address directly the market distortions it believes are created by the current formulas.

Reproposed Revisions to Market Data Dissemination Requirements

- Instinet Group generally favors the adoption of the various reproposed revisions to the Commission's rules relating to the independent dissemination of market data by SROs and their members outside an NMS Plan. Even with the clarifications provided in the Reproposing Release, Instinet Group continues to have specific concerns regarding the content of the proposed standards for such dissemination, the distinction between "core" and "non-core" data, and their implications.
- Instinet Group favors the adoption of the reproposed revisions to the consolidation requirements of redesignated Rule 603, but still questions the continued necessity of a formal consolidated display requirement in light of the ubiquity of market data in today's markets.
- Instinet Group continues to support the creation of market data advisory subcommittees to the NMS Plans, but believes that such entities are in no way a substitute for direct and immediate Commission action to address the serious and ongoing conflicts of interest and competitive concerns inherent in the NYSE and Nasdaq's control of the Network processors.

I. Reprosed Trade-Through Rule

A. The Commission Should Not Adopt the Reproposed Trade-Through Rule

Instinet Group continues to believe that a strict trade-through rule such as that proposed by the Commission is not in the best interests of investors or the markets. Our Initial Comment Letter laid out the case for our position in detail. We still believe our position is correct and, in fact, is strengthened by the most relevant data on trade-throughs provided by the Commission in its Reproposing Release.

We note, however, that we were willing to support the initial proposed trade-through rule, but this support was premised on the availability of an effective opt-out exception, which we believe would have mitigated many of the negative aspects inherent in a mandatory market interaction rule such as the proposed trade-through rule. Specifically, an opt-out exception would have preserved a continuing incentive for competition among markets, thereby allowing the demonstrated innovation and efficiencies such competition provides to continue in the Nasdaq market and to be brought to the market for NYSE-listed stocks, which has been insulated from competition by the ITS trade-through rule.

However, the Commission's reproposed trade-through rule does not include an opt-out exception or any other mechanism to counterbalance the rule's anticompetitive effects, inevitable unintended consequences, or costs. Consequently, we cannot support the adoption of the reproposed trade-through rule, even with the revisions made in the Reproposal. In this regard, we do not believe that the exclusion of manual quotations from the definition of "protected quotations" and the new so-called "tailored exceptions" to the reproposed rule are adequate substitutes for an effective opt-out exception.

B. The Commission's Own Economic Analysis Does Not Provide Support for the Adoption of any Trade-Through Rule

In the Proposing Release and Supplemental Request for Comment, the Commission's primary justification for the adoption of a strict trade-through rule for Nasdaq and NYSE stocks was to encourage the submission of limit orders by investors. The Commission, however, failed to provide any empirical evidence that the equities markets were suffering from a paucity of limit orders, that the ability of market participants to trade through displayed quotes was the culprit, or that the adoption of a strict trade-through rule would be the cure. In other words, there was no evidence of a widespread market failure that would necessitate a major regulatory response like the proposed trade-through rule.

In response to commenters, the Commission's Office of Economic Analysis ("OEA") undertook an analysis to attempt to determine the true extent of trade-throughs

on the markets for Nasdaq- and NYSE-listed stocks.[5] While issues could be raised regarding the scope of the analysis (four trading days in 2003) and its methodology, we will accept for purposes of argument what OEA described as "more conservative" estimates of the rates of trade-throughs in Nasdaq- and NYSE-listed stocks (*i.e.*, using a three second quote window, with trade-through volume identified as total displayed depth).[6] OEA found that the level of trade-throughs are extremely low in both Nasdaq- and NYSE-listed stocks, accounting for 2.5% of trades and 1.9% of volume in Nasdaq-listed stocks and 2.5% of trades and 1.2% of volume in NYSE stocks.[7]

These numbers alone should have given the Commission cause to step back and reconsider whether to proceed with its proposed rule, as its major justification for the proposal – that trade-throughs are deterring investors from placing limit orders, the fundamental building blocks of the market – is not substantiated. It is untenable to assert that investors are withholding limit orders from the market because they may be traded through 2.5% of the time, or put another way, because they will not be traded through only 97.5% of the time.

But instead, confronted with having a solution in hand without a real problem to solve, the Commission has attempted to find other purposes for the trade-through rule. In the Reproposing Release, the Commission cites the following as "weaknesses" in the Nasdaq and NYSE markets that are best addressed by the adoption of its reproposed trade-through rule, namely: a high degree of "slippage" on the NYSE market, and low fill rates for large orders and an excess of "transitory volatility" on the Nasdaq market.[8]

In this regard, while we ourselves made a point of a high level of slippage as being an issue in the NYSE market, we believe the more appropriate and less intrusive solution is to open up the NYSE market to competition by rescinding the ITS trade-through rule, rather than to dictate a specific solution by only granting trade-through protection to automated quotes, as the Commission seeks to accomplish.[9] In addition, we believe that the Commission is misplaced in its contention that low fill rates in Nasdaq stocks is a weakness of that market. Low fill rates are a phenomenon intrinsic to

[5] SEC, OEA, Analysis of Trade-throughs in Nasdaq and NYSE Issues (Dec. 15, 2004) at 2.
[6] We find no justification for the use of any number other than total displayed depth to analyze the volume of trade-throughs. The proposed trade-through rule itself defines a trade-though by reference to an execution at a price inferior to a "protected quote," which is limited to publicly displayed trading interest. Further, the Commission provides no basis for its assumption that latent (i.e., undisplayed) interest at the price of displayed depth would be displayed and thus protected under its new trade-through regime. To the contrary, our experience has been that market participants' primary motivation for not displaying their limit orders to the market is because the market impact that results from disclosing their trading intentions publicly increases their trading costs, not because they are concerned with having their orders traded through.
[7] Id.
[8] Proposing Release at 34-36.
[9] Id. at 35

electronic markets in which market participants are free to cancel and replace orders. By permitting market participants to immediately enter and cancel limit orders, market participants are more willing to provide liquidity to the market at more aggressive prices, knowing that they can cancel such orders on demand, which provides a net benefit to investors. To the extent that this explains low fill rates on marketable limit orders, we believe this is a strength rather than a weakness of the Nasdaq market. A further explanation for low fill rates on large marketable limit orders is that the Nasdaq market has a significant number of low-priced stocks. Due to the lack of publicly displayed sub-penny prices in these stocks, many market participants are forced to lock markets in large size (though relatively low dollar amounts), giving the appearance of an unfilled marketable limit order which, in fact, is really an order of a user that intentionally locked the quote of another market. In addition, many of the market centers in the Nasdaq market have significant reserve orders behind their displayed quotations. It is commonplace for market participants to route oversized marketable limit orders to attempt to interact with the reserve size behind a displayed quotation. This also could explain the lower fill rates. There is no reason to believe that the imposition of a trade-through rule on the Nasdaq market will have any real effect on fill rates in Nasdaq stocks. Finally, we would contest the basis for the insinuation by OEA that because it found the level of transitory volatility on the Nasdaq market to be higher than the NYSE market, this is somehow indicative of a shortage of liquidity on the Nasdaq market.

Moreover, the Commission provides absolutely no evidence, empirical or otherwise, that would suggest that a trade-through rule actually would address any of these purported "weaknesses" or, even assuming *arguendo* that it would, that it is the most effective or least disruptive and costly means of doing so. In the case of low fill rates and transitory volatility on the Nasdaq market, the Commission merely makes the conclusory statements that the rule is "designed to enhance depth and liquidity and thereby improve the execution quality of large orders in Nasdaq stocks" and "by promoting greater depth and liquidity help reduce excessive transitory volatility in Nasdaq stocks."[10] Such statements surely cannot substantiate the adoption of a rule that will impose substantial costs and have unknowable consequences for markets, market participants, and investors alike.

Finally, the Commission attempts to make the case for adopting a trade-through rule by stating that competitive forces are insufficient to strengthen intermarket price protection and improve the quality of trading in Nasdaq- and NYSE-listed stocks because of principal/agent conflicts of interest and market participants' free riding on displayed prices. Essentially, the Commission is making an argument that these are market failures that a trade-through rule is necessary to address. But again, the Commission's argument is undercut by its own analysis showing very low levels of trade-throughs on the Nasdaq and NYSE markets.

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[10] Id. at 35 and 36.

In conclusion, the familiar dictum "first, do no harm" applies with equal weight to regulators as well as physicians. Absent compelling evidence of market failure, the responsible and prudent course of action to avoid harming the nation's equity markets is for the Commission to refrain from adopting regulations with significant costs and unknown consequences. In this instance, we believe that the Commission's own analysis demonstrates that the level of trade-throughs in the Nasdaq and NYSE markets do not provide evidence of a market failure, and therefore the Commission lacks a sufficient basis for the imposition of a trade-through rule. We further believe there is no basis for the Commission's assertion that the reproposed trade-through rule would increase fill rates or reduce transitory volatility on the Nasdaq market (or, for that matter, whether these are in fact "weaknesses" that need to be addressed), and that the appropriate cure for excessive slippage on the NYSE market is to open that market up to competition by repealing the ITS trade-through rule, not by adopting a strict trade-through rule. Consequently, we strongly urge the Commission to refrain from adopting its reproposed trade-through rule.

C. The Commission Should Not Extend Any Final Trade-Through Rule to the Trading of Nasdaq-Listed Stocks

If the Commission determines to proceed with the adoption of the reproposed trade-through rule, however, we continue to believe that the Commission should limit the scope of the rule to the trading of NYSE-listed stocks. Given the existing high degree of market quality, robust competition and innovation, and low incidence of actual trade-throughs exhibited on the Nasdaq market, we can discern no legitimate justification for extending the rule to the trading of Nasdaq-listed stocks.

The Nasdaq market has arrived at its current high state of performance through the unleashing of competition in that market by the Commission in the aftermath of the Nasdaq market maker collusion scandal in the early 1990s. In that instance, a clear market failure was found, and the Commission appropriately acted through the adoption of the Order Handling Rules. The result has been the emergence of a high-quality, competitive and innovative market with an extremely low level of trade-throughs *in the absence of a trade-through rule*.

In the present case, no evidence of market failure exists to justify the imposition of a trade-through rule on the Nasdaq market, which would impose real costs and undercut the competition among markets that has driven the Nasdaq market to its current impressive level of performance and made this market the primary source of innovations in the U.S. securities markets over the past decade. Moreover, no evidence exists that the reproposed trade-through rule actually would reduce the level of trade-throughs on the Nasdaq market from where they are today, given that the Reproposal provides for a number of exceptions from the rule. Should the Commission therefore impose the costs of a trade-through rule on the Nasdaq market and put at risk the competition, efficiency,

and innovation that exists today in an attempt to reduce trade-throughs on that market from their already low levels? The only responsible answer is no.

In contrast, a legitimate case can be made for regulatory intervention in the NYSE market. The Commission's analysis has found that the level of trade throughs in the NYSE market, where the ITS trade-through rule currently applies, is comparable to that of the Nasdaq market. In our opinion, the low level of trade-throughs in the NYSE market is due to the historical centralization of order flow on the NYSE market, which the ITS trade-through rule has played a key role in preserving at the cost of blunting competition that would have spurred the NYSE's modernization into a truly automated market.

In this regard, the NYSE's total market capitalization is approximately four times greater than Nasdaq's and 93 of the 100 stocks in the S&P 100 are NYSE-listed stocks.[11] Yet, on a share basis, Nasdaq generally trades significantly more shares on a daily basis, while on a dollar volume basis, trading on the NYSE was only about 35% larger than Nasdaq in 2003.[12] The conclusion we draw from these numbers is that NYSE trading volume is artificially low and that trading costs are unnecessarily high. Further, as we noted earlier, every major innovation in the U.S. equity markets over the past 10 years has come from the Nasdaq market. Thus, in contrast to the Nasdaq market, a strong case can be made that regulatory intervention is legitimate to address the market failure in the NYSE market created by the ITS trade-through rule.

D. No Legitimate Justification Exists to Limit the Scope of Any Final Trade-Through Rule to the Market BBO Alternative or to Add a Block Trade Exception

While Instinet Group does not endorse the adoption of the reproposed trade-through rule, we see no legitimate policy or practical justification for limiting the scope of protected quotes under the rule by adopting the Market BBO Alternative instead of the Voluntary Depth Alternative. Once the policy determination is made that limit orders should be protected by force of rule, the only logically consistent course of action is to protect as many limit orders as possible. We anticipate little difference between the expected costs and damage to intermarket competition associated with a trade-through rule limited to top of book versus one that extends to depth of book. These costs and burdens overwhelmingly come from the imposition of a trade-through itself, not the scope of the rule. Consequently, we see no logical consistency in the positions taken by certain market participants who strenuously argued for the originally proposed trade-through rule as necessary to protect the sanctity of limit orders, yet now oppose the

[11] Reproposing Release at 149 (SEC data derived from annual reports of the NYSE and Nasdaq and statistics compiled by the World Federation of Exchanges); SEC, Division of Market Regulation, Comparative Analysis of Rule 11Ac1-5 Statistics by S&P Index, (Dec. 15, 2004) at 1.
[12] Reproposing Release at 149 (SEC data derived from annual reports of the NYSE and Nasdaq and statistics compiled by the World Federation of Exchanges).

Voluntary Depth Alternative. Their opposition exposes their positions on the original proposal as arrived at simply to advance their own commercial interests, not the interest of protecting limit orders, or for that matter, investors.

Finally, we see no legitimate or practical justification for the Commission to add any type of block exception to any final trade-through rule. Again, if the Commission has made the policy determination to protect limit orders by force of rule, the only logically consistent course of action is to apply such a rule to orders of all sizes. Market participants advocating a block exception under a trade-through regime are simply doing so to advance their own commercial interests.

II. Reproposed Restrictions on Market Access Fees

We continue to oppose the reproposed restrictions on market access fees for all the same reasons cited in our Initial Comment Letter. Specifically, Instinet Group strongly believes that the Commission should not adopt the proposed restrictions on the maximum market access fees that may be charged by broker-dealers and SROs, as such restrictions do not advance investor protection and impair Congress's goals for the NMS. The ability to charge transaction fees at prices determined by the market, not government fiat, is central to the ability of markets, particularly agency markets, to exist and enable investors to benefit from the services they provide. We believe that experience clearly demonstrates that competition among market centers has been effective in ensuring that market access fees do not impose any unnecessary burden on investors' access to NMS markets – the maximum market access fee charged by ECNs having declined 80% since 1996 – and that such competition continues unabated.

In addition, to the extent the Commission has concerns with issues related to market access fees, we believe that those issues can be addressed with much less intrusive alternatives than by imposing a cap on such fees. Moreover, Instinet Group questions whether the Commission actually possesses the requisite statutory authority to impose the proposed cap. Further, we have doubts that the proposed cap would stand up to judicial scrutiny under the Administrative Procedure Act as the Commission has not provided an adequate basis for the need for such a cap and has provided no basis for the proposed level of the cap.

That being said, however, if the Commission determines to adopt the reproposed restrictions on market access fees, we do believe that the Reproposal is an improvement on the initial proposal in several ways. First, by eliminating the attribution requirement, the Reproposal avoids creating a meaningless distinction between equally valuable trading interest that would only have served to raise the costs of market participants seeking anonymity for their orders and treated otherwise similarly situated ECNs, ATSs, and SRO trading centers in a disparate manner. Second, by limiting the proposed cap to a single accumulated fee limitation, the Reproposal reduces the potential for unintended consequences, and simplifies the ongoing administration of the cap.

Third, as for an appropriate amount for such an accumulated fee limitation, the Reproposal at least sets the cap at the prevailing $0.003 per share level for stocks priced above $1.00, which was arrived at through open competition among marketplaces. However, we believe that the Commission should reconsider the .3% of stock price cap for securities priced under $1.00 or impose similar price-based caps on NSCC and other clearing charges to prevent these costs from becoming disproportionately burdensome for market participants, particularly agency markets, who trade such stocks.[13]

Additionally, we note that the Reproposal would allow market makers and other non-ATS broker-dealers to charge an access fee to market participants that execute against their protected quotations. We believe that the promotion of full access to protected quotations and the equal regulation of trading centers requires the Commission to subject these market participants to the equivalent of the fair access requirement of Regulation ATS if these entities make the trading interest reflected in their protected quotations accessible by means other than through an SRO's trading facility.

III. Reproposed Restrictions on Locked and Crossed Markets

Instinet Group continues to believe that neither the public interest nor Congress's goals for the NMS would be advanced through the adoption of reproposed Rule 610(d), which would require SROs to adopt rules requiring their members to avoid locking and crossing the displayed quotes of other markets. For the reasons set forth in our Initial Comment Letter, we believe that enabling market participants to display quotations that lock or cross the market increases market transparency, efficiency, and encourages the display of limit orders by investors.

The Reproposal's minor concession of enabling market participants to lock or cross manual quotations will do little to mitigate the negative consequences to market efficiency and transparency that will result from the imposition of the restrictions. Consequently, we would request that the Commission refrain from adopting the restrictions on locked and crossed markets contained in reproposed Rule 610(d).

IV. Reproposed Market Access Requirements for SRO Trading Facilities and Trading Centers

Instinet Group believes that there is a strong public policy interest in ensuring that market participants have the ability to access, on reasonable and non-discriminatory terms, all publicly displayed trading interest in the NMS. As noted in our Initial Comment Letter, we believe that regulations requiring markets to be transparent and

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[13] See, DTCC, User's Guide to the NSCC Fee Schedule (Jan. 5, 2005 version), available at http://www.nscc.com/legal/nsccfeeguide.com.

accessible constitute the fundamental "rules of the road" for the NMS that provide the greatest benefits for all investors.

While we continue to support the goals of the reproposed market access requirements, we reiterate our request that prior to taking final action on the Reproposal, the Commission provide further clarification as to the meaning and application of the "unfairly discriminatory" standard used in the proposal. The proposal appears to be a subjective, rather than an objective standard, which would not lend itself to readily determinable criteria that market participants could follow to ensure their compliance with the proposed requirements.[14]

Separately, we appreciate the Commission's clarification in the Reproposing Release that the reproposed market access requirement will not prevent SRO trading facilities, their members, and trading centers displaying quotes through SRO display-only facilities from continuing to provide volume pricing discounts and reasonably taking into account the varying costs of providing service to different categories of customers in establishing pricing for such customers.

V. Reproposed Amendment to the Volume Threshold for the Application of the Fair Access Requirements of Regulation ATS

Instinet Group continues to support the adoption of the reproposed reduction of the volume threshold for the application of the fair access requirement of Regulation ATS to a particular security from 20 percent to five percent. We believe that reducing the volume threshold for the application of the fair access requirement would help to ensure equal regulation of, and a level competitive playing field among, all ATSs that are significant market centers in the NMS.

VI. Amendments to NMS Plan Market Data Revenue Allocation Formulas

A. Summary of Reproposed Allocation Formula

In the Reproposal, the Commission has made significant changes to its proposal formula to amend the CQ, CTA, and Nasdaq – UTP Plans to replace the existing formulas governing the allocation of the net income generated by the Plans to their SRO participants, which amounted to a total of $386 million dollars in 2003.[15] The Commission's stated intent is to establish a more broad-based measure of an SRO's contribution to the data streams of the three Networks covered by these Plans than is provided by the existing allocation formulas, which are based on transaction reports in

[14] In this regard, we note that the "unfairly discriminatory" standard differs from the standard used in the fair access requirement of Regulation ATS, which contains an objective component. See Exchange Act Rule 301(b)(5), 17 CFR 240.301(b)(5).
[15] Proposing Release at 203 (Section VI.C.1.). The net income for Network A (NYSE-listed) was $162.1 million, Network B (Amex-listed) was $95.6 million, and Network C (Nasdaq-listed) was $128.2 million.

the case of the CQ and CTA Plans and the average of transaction reports and share volume in the case of the Nasdaq – UTP Plan.

The Commission's reproposed formula continues to allocate each Network's total distributable net income among the securities included in a Network based on the square root of dollar volume of trading in each security ("Security Income Allocation") with the stated intent of redressing what it viewed as a disproportional allocation of revenues to a relatively small number of stocks with high trading volume to the detriment of the remainder of stocks with lower trading volume under the existing formulas. However, conceding that the initially proposed formula "was very complex and may have been difficult to implement effectively,"[16] the reproposed formula reworks the mechanism by which the net income for each security in a Network is then allocated to the individual SROs. In the initial proposal, the SIA for each security in a Network was allocated to each SRO through three measures: (1) the SRO's proportion of trading in that security ("Trading Share") (50%); (2) the SRO's proportion of quotes with prices that equal the NBBO ("Quoting Share") (35%); and (3) the SRO's proportion of quotes that improve the NBBO ("NBBO Improvement Share") (15%). The Reproposal eliminates the NBBO Improvement Share measure and allots its share of the SIA to Quoting Share. Thus, under the Reproposal, the SIA for each security in a Network is allocated to each SRO in an amount generally equal to 50% of the SRO's Trading Share in the security and 50% of the SRO's Quoting Share in the security. The Reproposal also eliminates the ability of manual quotes to earn an allocation under the Quoting Share measure.

B. The Commission Should Not Adopt the Proposed Formula as it Would Not Achieve Its Intended Goals, while Unnecessarily Creating Significant Market and Economic Distortions

Instinet Group believes that while in many respects the Commission's proposal is well-intentioned, it should not be adopted as it fails to provide any appreciable benefits for investors or advance Congress's goals for an NMS, raises significant potential risks for investor harm, and the distortions it seeks to address can be better dealt with through less intrusive means.

With respect to the SIA, we believe that the use of a square root of dollar volume function to determine the SIA for each Network security is hardly a "marginal" reallocation of Network revenues between the most actively traded stocks and less actively-traded stocks. If the Commission nevertheless decides to adopt an SIA that reallocates income among Network securities, Instinet Group recommends that the Commission select a function that produces a more modest reallocation of revenues from actively-traded to less actively-traded securities.

[16] Reproposing Release at 156 (Section V.A.3.a.).

As we stated in our initial comment letter, the fundamental problem with the Commission's proposed Quoting Share formula stems from the inherently low cost for market participants to generate quotation information and the consequent high potential for gaming behavior in any formula that attempts to reward such behavior. Recognizing this problem, the Commission's proposed formula attempts to anticipate and prevent such behavior by micromanaging it away through arbitrary judgments as to value of certain market information, the consequence of which is to introduce even more distortive effects on market participants' behavior, create substantial potential for gaming behavior through their complexity, and reach arbitrary results.

In this regard, the Quoting Share measure seeks to reward quotes at the NBBO by providing SROs with credits for time and dollar size at the NBBO. While the Reproposal eliminates one easily identifiable aspect of potential gaming behavior by eliminating credits for manual quotations, significant potential for gaming behavior exists. For example, market participants can gain quote credits simply by posting and canceling quotes in illiquid stocks. While the Commission appears to put its faith in order-routing technologies to impose market discipline on such behavior by reducing the potential for low-cost quotations at the NBBO to gain quote credits,[17] we are not as sanguine that this will in fact be the result.

The reproposed Trading Share measure also creates arbitrary results in an attempt to address issues with the existing formulas. This measure rewards SROs for their pro rata share of transaction reports in a security, but only includes transactions with a dollar volume below $5000 on a proportional basis (e.g., a $2500 trade would constitute ½ of a qualified trade report). The Commission states its belief that its revised approach would reduce allocations for "shredded trades" while still recognizing the price discovery value of small trades.[18] The $5000 threshold for full credit as a qualified trade report still produces arbitrary results in most cases (although somewhat less so than did the initially proposed threshold).[19] Further, as the Division of Market Regulation reportedly has requested each SRO to address the practice of trade shredding by modifying their rules, adopting any threshold for qualified trades would seem to be particularly unwarranted.[20]

As a result, we believe the reproposed allocation formula, while less complex than the initially proposed formula, remains an arbitrary exercise that, if adopted, may well introduce many more economic and market distortions than it would resolve.

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[17] Reproposing Release at 159 (Section V.A.3.b.)
[18] Proposing Release at 209 (Section VI.C.2.b.i.).
[19] For example, the proposed $5000 share floor for eligible trades would only provide ½ credit to a 2000 share execution in a security trading at $2.49, while providing full credit to a 200 share execution in a stock trading at $25.00. Under almost all possible permutations of relative trading volume, however, the execution in the stock trading at $2.49 would have greater informational value to the market.
[20] Deborah Solomon, SEC Urges U.S. Stock Markets to Help Stop Splitting of Trades, WALL ST. J., Jan. 25, 2005, at C3.

C. The Commission Should Instead Take Discrete, Less Intrusive Actions to Directly Address Certain Issues Relating to the Current Market Data Revenue Allocation System

Instinet Group continues to believe that the Commission would best serve the interests of investors and the Congress's goals for the NMS by taking certain discrete, less intrusive measures to address directly the issues related to the current market data revenue allocation system. In this regard, we reiterate our previous suggestions that the Commission should specifically prohibit the practice of tape shredding, continue to enforce existing prohibitions on wash sales under the Exchange Act,[21] and consider revising the CQ and CTA Plans to account for share volume as well as volume of transactions in allocating market data revenues generated by the sale of data from Networks A and B.

VII. Other Reproposed Changes to Market Data-Related Regulations

A. Revisions to Existing Rules Regarding the Dissemination of Market Data

Instinet Group continues to generally support the adoption of the revisions to the existing rules governing the distribution and display of market data, with certain limited exceptions.

1. <u>Revisions Relating to the Independent Dissemination of Trade Reports and Quotation Information</u>

The Commission is reproposing its revision of Rule 11Aa3-1 (redesignated as Rule 601) to rescind the prohibition against the independent dissemination of trade reports by SROs and their members outside an NMS Plan. With respect to the independent distribution of quotation information, while current rules do not prohibit such distribution, the Reproposal would establish standards for the distribution of such information. Specifically, the Commission is proposing to require that any market participant that is the exclusive source of market information make such information available to securities information processors on terms that are "fair and reasonable" and to require any SRO, broker, or dealer that distributes market information to do so on terms that are "not unreasonably discriminatory."

Instinet Group supports the reproposed rescission of the prohibition against the independent dissemination of trade reports by SROs and their members outside an NMS Plan. We do, however, have continuing concerns with the Commission's establishment of standards over the independent distribution of trade reports and quotation data by SROs, brokers, and dealers.

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[21] Section 9(a)(1) of the Exchange Act, 15 U.S.C. §78i(a)(1).

While the Commission again took pains in the Reproposing Release to point out that it is establishing a lesser standard for "non-core" versus "core" data ("not unreasonably discriminatory" versus "fair and reasonable") the Commission provides very little in the way of guidance as to (1) what data is "core" data and "non-core" data; and (2) what is the practical difference between the "not unreasonably discriminatory" and "fair and reasonable" standards. In addition, it appears that the determination of what is "core" data is left to the Networks, albeit with the approval of an NMS Plan amendment accomplishing this by the Commission. This could lead to the result that Network participant markets could agree among themselves to offer a non-SRO's proprietary data for redistribution through the Network without any input from the affected non-SRO other than through the Commission's comment process for amendments to NMS Plans.

We do, however, appreciate the Commission's response to our request for clarification to its statement in the Proposing Release that its proposed standards "would prohibit, for example, a market center from distributing its data independently on a more timely basis than it makes available the 'core data' that is required to be disseminated through a Network processor." In the Reproposing Release, the Commission made clear that this statement does not mean that a market center would have to artificially slow the independent delivery of its data to correlate with restrictions imposed by a Network processor based on the processor's capacity or other limitations.

2. <u>Revisions Relating to the Consolidation of Trade Reports and Quotation Information</u>

The Commission is reproposing the adoption of substantial revisions to the consolidation requirements of Rule 11Ac1-2 (redesignated as Rule 603). First, the proposals would eliminate the requirement to provide a complete quote montage and limit the consolidated display to the prices, sizes, and market center identifications of the NBBO and last sale information. Second, the proposals would narrow the range of contexts triggering the requirement to those in which a trading or order routing decision could be implemented. Finally, the proposals would streamline the Rule's text to eliminate provisions tied to specific and generally outdated technologies.

Instinet Group reiterates its belief that these proposals should be adopted as they would reduce some of the unnecessary regulatory burdens that the current Rule imposes on market participants. However, we continue to question whether a formal requirement to provide a consolidated display remains necessary in the context of today's information-rich markets and the proposed narrowing of the information required in a consolidated display, as broker-dealers and other market participants would appear to have sufficient incentives to provide a consolidated NBBO without a formal requirement to do so.

B. Creation of Market Data Advisory Committees

Instinet Group supports the reproposed amendment to the NMS Plans that would require the Plans to appoint advisory committees. We have little hope, however, that the appointment of such committees will have any real impact on the primary defects in the current NMS Plan arrangements, which stem from the conflicts of interest inherent in the continuing control of the exclusive processor function by the NYSE and Nasdaq, the competitive advantages such control has provided these entities, and the ability of Plan participants to block competitive initiatives of other participant markets.

Consequently, we reiterate our request that the Commission take action to meet its obligations under the Exchange Act and to address our previously stated concerns by adopting effective corporate governance safeguards for Network processors, require the NYSE to divest itself of its controlling interest in SIAC, or amend the CQ and CTA plans on its own initiative to appoint a new exclusive processor for Network A securities. Furthermore, we request that the Commission take the initiative to complete the process of replacing Nasdaq as exclusive processor for Network C securities, a process that has been underway for several years but still has not been completed.[22]

VIII. Reproposed Restrictions on Subpenny Quotations

A. The Commission Should Not Adopt the Proposed Restrictions on Subpenny Quotations

While recognizing that there may be some legitimate concerns with subpenny quoting and trading on a market-wide basis, we firmly believe that market forces, rather than government intervention, should determine the appropriate quotation increment for a particular security. Government intervention to fix the quotation increment will only cement the status quo and prevent marketplaces from making subsequent innovative changes to their quotation increments to respond to the needs of investors.

If the Commission adopts the proposed prohibition on subpenny quoting, however, market centers will lose the necessary flexibility to respond to the needs of investors and the marketplace. In the end, the real harm will come to investors, as spreads in certain securities will be fixed artificially at a level that is higher than necessary, which will unnecessarily increase investors' transaction costs.

We believe that INET's recent experience in allowing a limited number of securities to be quoted in subpenny increments demonstrates that there are securities other than ETFs for which subpenny quoting is appropriate. INET is providing the

[22] See Exchange Act Release No. 43863 (Jan. 19, 2001), 66 FR 8020 (Jan. 26, 2001) (File No. SR-NASD-99-53) (discussion of replacement of Nasdaq as exclusive processor).

Commission under separate cover an analysis of its experience with subpenny increments in these securities that we believe will provide ample evidence in support of our position.

B. Insufficiency of Reproposed Exemptive Relief

Reproposed Rule 612(c) allows the Commission to exempt market participants from the application of the reproposed prohibition. We believe, however, that the exemptive relief available in reproposed Rule 612(c) remains insufficient, as it would appear to be difficult to expect market centers to appeal successfully for relief when they are prohibited from demonstrating that a true subpenny market exists for a particular security. In this regard, we would recommend that the Commission adopt explicit criteria for exemptive relief in a particular security, such as regular quoting at the minimum increment with significant size at the bid and offer.

C. Request for Specific Exemption for QQQQ and Other NMS Stocks

If the Commission determines to proceed with the proposal, however, we request that the Commission provide a specific exemption from the proposed rule for QQQQ and certain other NMS Stocks. In the case of QQQQ and other ETFs, we are encouraged by the Commission's statement in the Reproposing Release that "[a]t this time, the Commission believes that a basis likely may exist to grant an exemption from the sub-penny quoting prohibition for QQQQ and perhaps other actively-traded ETFs." We believe that INET's analysis will demonstrate that there are a number of other actively traded securities that the Commission should exempt from the application of any prohibition it may ultimately adopt.

D. Acceptance of Sub-Penny Quotations

Reproposed Rule 612(a) continues to prohibit market centers and broker-dealers from displaying, ranking, or even <u>accepting</u> quotations in NMS Stocks that are priced in subpennies. One commenter argued that a market participant should be allowed to accept sub-penny quotations if it consistently re-prices such quotations to acceptable increment and does not give the sub-penny quotations any special priority for ranking or execution purposes. The Commission disagreed with the commenter citing that it believed their was little purpose for allowing market participants to accept such quotations and the rounding of such quotations could cause confusion among investors. We did not ourselves comment on this issue in our initial comment letter as we believed that the term "accept" would not preclude a market center from repricing an order to the appropriate increment upon receipt of the order, but prior to placement in its matching system. We respectfully disagree with the Commission that there is any real potential for confusion among investors that would merit market participants making the changes to their systems to comply with this aspect of the prohibition.

IX. Conclusion

Instinet Group again appreciates the opportunity to offer its comments on reproposed Regulation NMS. We look forward to the prospect of working together with the Commission in modernizing the regulatory framework of the NMS, based on sound empirical data, to enable competition among markets and the application of technological advancements to benefit investors in accordance with Congress's goals for the NMS.

* * *

If you have any questions regarding our comments, please do not hesitate to contact me directly at 201.231.5501, or Jon Kroeper, FVP and Associate General Counsel, Instinet Group, LLC at 202.898.8438.

Sincerely yours,

Edward J. Nicoll
Chief Executive Officer

cc: The Honorable William J. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner

Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

Giovanni Prezioso, General Counsel, Office of General Counsel

FINAL VERSION

Remarks of Mr. Edward J. Nicoll

Chief Executive Officer
Instinet Group Incorporated

The American Enterprise Institute: The SEC's Regulation NMS
January 11, 2005

Good Afternoon. I am delighted to be back at AEI and pleased to have the chance to talk with you today about our Nation's market structure. Looking across this full room, I recall those early and lonely days – only some five years ago – when Instinet and a firm it subsequently purchased - Island, tried to meet with almost anyone in Washington to talk about these market structure issues. Our enthusiasm and persistence drew blank stares. I fondly recall seeing one of my colleagues speaking enthusiastically to a senior Republican member of the Senate Banking Committee, and until at last the Senator interrupted him by saying, "Oh, you are the President of Island, I thought you said President of Ireland," at which point the conversation abruptly ended. Hopefully, we've come a long way since then.

More seriously, I believe that the work AEI has done over the past few years on the issues covered by Regulation NMS has been a valuable service to investors. Under Chris DeMuth's leadership, AEI has continued its critical role in defining and shaping strong public-policy recommendations, informed by serious academic study and practical experience. In particular, I applaud Peter Wallison's efforts to articulate how much is at stake in this debate and to lay out – in his usual clear and persuasive fashion – the right road to reform. I suppose it's not exactly a newsflash to confess that Peter and I are in violent agreement on most aspects of the Reg NMS debate. Peter, Jim Glassman, and others have reminded us of a core and central proposition: that is, unless there is compelling data showing a market failure, the most efficient results are achieved through competition rather than regulatory mandates.

This afternoon, I would like to spend a few minutes reviewing Instinet Group's position on the portion of Regulation NMS that has been receiving the most attention – the issue of the trade-through rule.

The basic philosophy behind our position then and now is that nobody knows what the best market structure is. Modesty in such circumstances is not only good public-policy, but the only way to proceed. Nobody knows how the markets should or actually will evolve. As a result, we need an equity market structure that allows different market models to compete and innovate. To get there, though, we must have a regulatory structure that promotes competition and innovation, not a structure that inhibits them. Over time, the marketplace itself will determine the most efficient market model and investors will reap the benefits.

One of the difficult things about this debate is that the costs of over-regulating and harming competition are impossible to calculate. Are our equity markets so successful because of, or in spite of, our current regulatory structure? I believe there are hidden costs to investors due to the current trade through rule. For example, when comparing NYSE and NASDAQ market volumes, the NYSE has companies with total market capitalizations approximately 4 times greater than the NASDAQ market. 93 of the S&P 100 stocks are NYSE companies. In short, the NYSE lists most of the companies that are household names. Yet on a share basis, the NASDAQ market

trades more shares nearly every day. And when you compare the dollar value of shares traded per day, the NYSE is only approximately 20% larger despite being four times the size of NASDAQ.* My belief is that NYSE volume is artificially low and that trading costs are unnecessarily high, due to regulatory barriers and operational inefficiencies caused by a lack of competition. How much does this cost investors every year? Nobody knows.

Over the course of five years coming to Washington to talk about the proper regulatory structure for our markets, I'm proud of the fact that Instinet has never asked anyone – from legislators, to regulators, to public policy experts -- to change how any other market operates. Instead, we've simply asked for the ability to compete on equal terms against all different types of market models. Given this basic premise, we have advocated the elimination of the trade through rule because it dictates how markets must operate and how investors must trade, inhibiting innovation and imposing hidden but possibly substantial costs on investors.

I find the debate regarding the trade-through rule to be very instructive as to how difficult it is to eliminate regulations that may be counter-productive. In looking at the SEC's most recent re-publication of Regulation NMS and comparing it to the original defenses of the trade through rule we heard a few years ago, there has been a shift in the debate. Initially, the chief rationale in defense of the trade through rule was that it was necessary to protect investors from inferior executions. In other words, without a trade through prohibition, unscrupulous brokers would execute investor orders at prices other than the best available price.

But when we said, "fine, let investors only knowingly opt-out of the trade through protections," the rationale for preserving the trade-through rule shifted. The latest rationale for continuation of the trade through prohibition is that it is necessary to encourage limit orders. So even if the person trading through does so knowingly, the act of trading through does harm to the market generally by discouraging limit orders. Limit orders, it is said, are the building blocks of our markets so the more protection there is for limit orders, the greater the liquidity in the marketplace.

I agree with the SEC and others who say that limit orders are critical to a strong marketplace. That is one reason why INET, the electronic marketplace part of my business, pays broker-dealers who post limit orders while charging customers who access this liquidity. In contrast, the NYSE actually charges for many types of limit orders and does not charge for market orders. Thus, while the NYSE proclaims the sanctity of limit orders, its very policies -- as reflected in its actions rather than rhetoric --undermine its own position.

But while I agree that limit orders are important, I don't believe that the adoption of a trade-through rule is going to lead to greater liquidity in the marketplace. Not only do I believe that liquidity will not be improved materially, but I believe that there will be substantial costs to innovation and competition that will far outweigh the benefits, if any, of a trade-through prohibition. While I or anyone else are certainly free to speculate on different outcomes, we actually do have real-life, ongoing evidence to test whether a trade through rule is necessary to promote the display of limit orders—it's called the market for NASDAQ-listed stocks.

Three major markets, INET, ARCA and NASDAQ all trade the same securities without a trade through rule. How often do they ignore better prices in each other's markets? Let's turn to the very study the SEC itself is using to justify KEEPING and EXPANDING the trade through rule. The SEC's Office of Economic Analysis examined 4 trading days in late 2003 and found that NASDAQ share volumes identified as trade-throughs were 1.9% of the volume if trade through volume is limited to displayed depth. In other words, only about 2% of the volume executed on

the NASDAQ market was executed at prices inferior to the quoted price when the depth of the market is taken into account. Since, as I mentioned above, the key rationale for preserving and extending the trade-though prohibition is now that trade-throughs discourage the posting of limit orders, the most relevant statistic is the volume of shares displayed in the quote that are traded through—which according to the SEC's study is less than 2%.

To make this point more clearly, let's assume that 2 people were waiting in line for a movie. Now assume that 5 people arrive, bypassing the 2 people in line and going directly into the theater. Now, if we want to know how many people were disadvantaged by line skipping we would say 2. We would not reference the 5 people that by-passed the line. To carry through our example, what the SEC study shows is that 98 out of 100 people waiting in line entered when it was their turn. Further, the remaining 2 people may very well have entered despite being by-passed. The question is, does that 2% risk, assuming it is even an accurate measure, reduce the number of people willing to stand in line?

I don't think so. I don't think it's even close. And I certainly don't think it warrants costly regulation.

Now, let me be clear. I believe that institutions and other market participants certainly do have concerns about posting limit orders. But the root of their concern is not the 1.9% of their displayed size that is traded through, but market impact. In short, they don't want other market participants to know their intentions because disclosure of their limit orders ultimately raises their trading costs. Indeed, one of the main business propositions of the other part of my business, Instinet, our agency brokerage business, is that we reduce implicit and explicit trading costs resulting from, among other things, market impact. Every day I deal with market participants who tell me that their priority is minimizing costs from market impact. So contrary to the SEC's claims in proposing Regulation NMS, I don't believe there will be any material increase in displayed size due to a new trade-through regime.

Unfortunately, I understand that the current conventional wisdom in this town is that the final regulations will not include elimination of the trade-through rule nor is an effective opt-out provision part of the reproposal. Rather, as the re-published Regulation NMS makes clear, the only key remaining question is whether the trade-through rule should apply to only the best priced quotes or the full depth of book. This is a fascinating turn of events.

Let's recall what supporters of the trade through rule originally said about protecting limit orders. Phrases like "bedrock of our markets" were being thrown out at every turn to describe any and all limit orders. Well, be careful what you ask for, my friends. It turns out that supporters of the trade-through rule were so convincing in their arguments that the SEC basically said, "If you like top of book limit order protection, then you are going to love limit order protection for the full depth of book!"

Then began a ferocious backpedaling. The very people who were preaching about the sanctity of limit orders now said they really meant ONLY THE BEST PRICED limit orders should be protected. In other words, they make the unconvincing argument that while trading through the best price discourages limit orders, trade-throughs of orders at less than the best price don't similarly discourage limit orders. Or, to go back to our movie-line analogy, they are essentially saying that the rules should ensure that nobody cuts in front of the first person in line, but that it's quite alright to cut in front of everyone else in line.

I remember a hearing where Senator Schumer gave a simple yet compelling example. He said if his father posted a limit order and yet saw transactions being executed at inferior prices that his father would feel disadvantaged and lose confidence in the market. But, apparently, according to the NYSE, Senator's Schumer's father may feel disadvantaged if he is traded through when his price is the best price but not when it is only the second best price available.

Not surprisingly, I fail to see any logical consistency in this position, since either limit orders should be protected or they shouldn't. But I'd like to assert today that what's driving the most recent NYSE position is not necessarily intellectual consistency, as much as plain and simple business survival. The NYSE got caught in seeing its articulated position carried to its natural conclusion, and now realizes that it would be impossible for it to live under such a regime. Not surprisingly, the NYSE has to shovel some of the toothpaste back in the tube. The NYSE realizes that its key competitive advantage -- the informational monopoly enjoyed by members on the floor that effectively forces everyone to come to the floor for price discovery -- will be compromised by a depth of book trade-through rule. Its most cherished asset – the volume on the floor – would become fair game for other market centers. That must be protected at all costs.

As a result, the NYSE had to launch a mini-campaign to reposition its arguments. Recently, the NYSE's John Thain wrote in the Wall Street Journal-and I quote:

> "Such a proposal (HE IS REFERRING TO DEPTH OF BOOK) would transform our market system into a virtual Consolidated Limit Order Book or CLOB. The CLOB has been proposed in the past, debated at length, and wisely and repeatedly rejected by previous SEC chairmen and commissioners for a number of reasons; foremost among them, it would convert our dynamic, diverse, and internationally competitive markets into a government-mandated, one-size-fits-all monolith."

Interestingly, that has been Instinet's argument against ANY trade though rule from the start. But like the circus contortionist, the NYSE must explain why they support top of book trade-through but not depth of book. Again, although basic logic tells us that depth of book trade-through would do far more to protect limit orders, the NYSE must unearth some value in just a top-of-book trade through:.

> Here is Mr. Thain's attempt in the same article:
>
> "In an electronic-only environment, where exchanges must break up orders to attempt to chase displayed quotes from market-to-market, large orders of stock will be difficult to execute. Instead, these large orders may go elsewhere, to be traded in private markets or overseas."

Notice how the NYSE has redefined the terms of the debate. The old rallying cry had been that a trade-through rule is necessary to protect and thereby encourage the display of limit orders. Now the NYSE is saying in effect, "if we have to really protect all limit orders then it will hurt our floor-based market." And that "big investors need to be able to ignore better prices in order to get trades done." But what about that individual investor's limit order the NYSE once felt so compelled to protect? Will that investor feel better because although he was traded through, he facilitated a negotiation on the floor of the NYSE?

To be fair, I see nothing wrong about a business advancing a public-policy position based on its ability to prosper under such a regime. But let's at least be honest about it, my friends, and not

dress it up in our Sunday best and call it serving individual investors. More importantly, when it comes to making public-policy, it should never be based on the needs of the NYSE or any other market center for that matter. If we believe that limit orders should be protected, then let that principle truly guide our actions in a logically consistent manner by protecting as many limit orders as possible with the full depth of book alternative.

In closing, then, let me return to where I started. As AEI and others have reminded us in many contexts over the years, any initiative for new regulation must be based on clear, compelling evidence of market failure. That's the only way to justify the additional costs of further regulation versus a reliance on market competition to drive innovation. I don't believe a 1.9% trade-through rate represents a market failure.

While the NYSE and its allies still insist on some sort of tortured trade-through rule that simply furthers their own business model, the rest of us should insist on regulations based on coherent policy arguments and sound economics. The case for the trade-through rule fails on both accounts.

Thank you.

*Data from the SEC's proposal of Reg NMS Exchange Act Release #50870, December 16, 2004.

Fidelity
INVESTMENTS

Statement for the Record

on

"Market Competitiveness under the Securities and Exchange Commission's Re-Proposed Regulation NMS"

before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

February 15, 2005

Introduction

Fidelity Investments commends Chairman Baker, Ranking Member Kanjorski and other distinguished Members of the Subcommittee for their review of securities market structure, and in particular the Securities and Exchange Commission's (SEC) re-proposed Regulation NMS. We are pleased to offer our views of the re-proposed Regulation NMS.

The Commission has invited comment on two versions of an inter-market trade-through rule: (1) one that would "protect" only the best bid and best offer displayed in each market center for any stock (the "Top of Book" rule) and (2) another that would "protect" additional bids and offers below each market center's top of book if the market center chooses to designate those additional limit orders for protection (the "Depth of Book" rule). At the Commission's open meeting last December, Commissioner Glassman urged her fellow Commissioners to seek public comment on a third approach: namely, that the Commission stay its hand and adopt no trade-through rule at all.

We concur with Commissioner Glassman's position and oppose any rule which would deprive informed investors of the freedom to choose among competing markets in carrying out decisions to buy or sell a security traded in more than one market:

- The SEC's trade-through rule would deny an investor the right to take into account other important factors that bear upon the choice of market and best execution – for example, market data costs, transaction costs, technological innovation, enforcement of trading rules, quality of market surveillance, protecting the anonymity of investors, and elimination of informational and trading privileges of floor members.

- So long as bids and offers are made available to investors on a timely and continuous basis, and investors have ready access to competing market centers, the government need not – and should not – deprive investors of the freedom to choose among markets. This is especially so for institutional investors who owe fiduciary duties to the funds or accounts under their management. With market transparency and accessibility, investors will reap the benefits of vigorous competition among markets.

- Accordingly, we urge this Committee to send a clear signal to the Commission to adopt no trade-through rule at all and we are gratified that TIAA-CREF, among others, has recently announced its position against a trade-through rule.

In the balance of our statement, we wish to bring three additional issues to the Committee's attention: (1) the sequence for Commission consideration of a trade-through

rule and the NYSE's "hybrid market" proposal, (2) the re-proposed rule's dropping of the "opt-out" right for informed investors and (3) the flaws in the SEC's economic study that the Commission offers in support for a trade-through rule.

I. **The NYSE's hybrid market proposal and the Commission's trade-through rule proposal**

We have heard from many quarters that one important reason to support the Commission's trade-through rule proposal is to motivate the New York Stock Exchange to transform itself from a "slow" market to a "fast" one – a market that will allow for automated trading, including automated "sweeping" of its limit order book. If this view has merit, we suggest that the Commission need ***not adopt*** a trade-through rule to achieve the desired end. The NYSE has, in fact, proposed a hybrid market proposal that purports to allow for automated trading of orders, regardless of their size. We are encouraged by this step, although we have a number of concerns regarding the NYSE's proposal. For its part, the NYSE, through its representatives, has stated to us that its hybrid market proposal does ***not*** depend on the Commission's adoption of a trade-through rule.

It seems to us that the Commission should first take up the NYSE's hybrid market proposal for consideration before acting on its own proposed trade-through rule. Does the NYSE rule effectively respond to investors' needs? Will it transform the NYSE into a fast market? Should floor members and specialists be allowed to insert undisclosed orders into the NYSE's electronic limit order books? With regard to all trading on the NYSE, should the NYSE be required to grant time priority (as its rules currently do not do) to investors' orders entered in the specialist's limit order book over orders that are sent to floor brokers later in the trading day? These are issues concerning the NYSE's market that should be addressed by the Commission before it decides whether an ***inter-market*** trade-through rule is necessary or appropriate.

II. **The "Opt-Out" Right**

The re-proposed Regulation NMS proposes to drop the "opt-out" right that the Commission included in its initial trade-through rule proposal. We have urged the Commission to retain the opt-out right and do not believe that the Commission's rationale for dropping it is sound.

The Commission recognized in its initial proposed Regulation NMS that an informed investor may have legitimate reasons to send its order to a particular market center, even though another market center may be displaying opposite-side limit orders at a price superior to the price that the investor is willing to pay or receive in its market center of choice. This is particularly true for institutional investors, like the Fidelity funds, that typically trade in large blocks. The Commission observed (at p. 23) of its initial release:

> "Large traders may ... want the ability to execute a block immediately at a price outside the quotes, to avoid parceling the block out over time in a

series of transactions that could cause the market to move to an inferior price."

"A further benefit of providing investors with the flexibility to choose whether their orders should trade through a better quote is that it might create market forces that would discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation *or service provided by a market center*, they could choose to have their orders executed without regard to that market's quote, thus putting pressure on the market to improve its services." (Emphasis added)

In its re-proposed Regulation NMS, the Commission explains that a trade-through rule that applies only to markets with "fast" quotes obviates the need for an opt-out right for informed investors. We respectfully, and strongly, disagree for the following reasons:

- Even if markets are fast, the risk remains real, and substantial, that an institutional investor, seeking to acquire or dispose a large block of stock will be put to a distinct and unfair disadvantage if it is deprived of the ability to negotiate, at one time and at a specified price, an all-in price for its block trade with a dealer. It is not unusual for mutual funds to do block trades consist of tens of thousands and sometimes hundreds of thousands of shares. It cannot be assumed that the displayed liquidity across market centers under a trade-through rule will always – or typically -- be sufficient to satisfy even a significant portion of our funds' block trades. As a result, whether markets have fast quotes or not, the government's imposition of a trade through rule may often cause many mutual fund investors (consisting of small retail and pension plan investors) to receive an inferior price for their funds as the market moves away from the desired price.

- An opt-out right also motivates market centers to compete for order flow with innovative trading technologies, shareholder services and quality of market center regulation. Without choice of trading venues, the Commission will seriously impair the ability of an informed investor to "discipline" a market center for other legitimate reasons – for example,

    - high transaction fees,

    - high fees for viewing limit orders away from the best bid or offer,

    - unfair informational and trading advantages given to members solely by virtue of their presence on a trading floor,

- o leakage of information by floor members regarding the identity of a large investor seeking to trade in large quantities in a given stock on a given day,
- o abusive trading by specialists or floor members that are not promptly addressed by the market center's surveillance and enforcement arms,
- o the ability of floor members to reap the benefit of "free" puts and calls represented by investors' limit orders, a benefit that facilitates "penny jumping" by floor members – a practice that would survive a trade-through rule for the very reason that such trading takes place inside the spread, and
- o failure of a market to give time priority to limit orders over orders sent to floor brokers later in the trading day.

We respectfully submit that it ill behooves the government to decide that the only legitimate interest that an informed investor may have in choosing among competing market centers is whether a market center has "fast" quotes that happen to meet the minimum threshold set by the government as to what constitutes "fast."

- In proposing to eliminate the opt-out right, the Commission, inappropriately, is choosing to confer advantages to some investors over others. As noted above, the ability to do block trades quickly, and at a specified price, is a legitimate interest of an institutional investor – an interest that bears directly on the ability of the institutional investor to obtain best execution at an "all-in" price. The Commission implicitly acknowledges this legitimate interest of the institutional investor in its re-proposing release (at p. 59), stating that "advocates of the opt-out exception have failed to consider the interests of all investors – both those who submit marketable limit orders and those who submit limit orders." For our mutual funds, our fiduciary duty is to consider the interests – **and only the interests** – of our fund shareholders not the interests of all other investors in the market. The government should not be in the business of tilting the scales against mutual fund investors to favor other market participants. We hasten to add that this is not a "big investor vs. small investor" issue. The average account of a shareholder in a Fidelity domestic equity fund is roughly $10,000. We suggest that this average account size is smaller than the account size of the typical individual investor maintaining an account at many, if not most, full service brokerage firms.

- The Commission advances as a reason for depriving institutional investors of an opt-out right that these investors "free ride" on prices established by retail-sized displayed limit orders. We along with TIAA-CREF seriously

question the underlying economic assumptions of this position. The price-formation process in our equity markets reflects information stemming from all trading interests, large and small. Almost a third of the reported volume on the NYSE in 2004 was of block size, typically representing undisplayed institutional trading interest.[1] The Commission does not discuss in the re-proposing release the economic literature relating to the impact of block trades by institutional investors in the price discovery process. We believe that it is incumbent upon the Commission to address available economic studies if it proposes to eliminate its earlier proposed opt-out right for informed investors on the unproven hypothesis that institutional investors "free ride" on prices displayed by retail-sized limit orders.

In the place of an opt-out right, the Commission is proposing a "benchmark order" exception. This exception would allow a block trade in one market to "trade through" superior opposite-side quotes on another market if the benchmark order is executed "at a price that was not based, directly or indirectly, on the quoted price of the ... stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made."

The example of a benchmark order offered in the re-proposing release (at p. 87) is a block trade of 100,000 shares to which a dealer commits at 9 a.m., at a price equal to the volume-weighted average price ("VWAP") from the opening until 1 p.m. The benchmark order exception would allow the dealer to execute the trade at 1 p.m. even though the VWAP would result in a trade-through, in the Commission's words, of "better-priced protected quotations at other trading centers."

- The Commission offers little explanation as to why this type of trade-through is acceptable, whereas trade-throughs at dollar-specific prices at the time of the commitment by a dealer to its customer somehow are not. We submit that no meaningful distinction can be – or should be – drawn between the two types of block trades.

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1 For 2004, blocks (trades of 10,000 or more shares) on the NYSE as a percentage of aggregate NYSE reported trading volume were as follows:

January	38.5%	February	36.1%
March	33.9	April	33.2
May	29.2%	June	30.2
July	30.5	August	27.6
September	29.8	October	31.0
November	29.9	December	31.2

Source: NYSE Online Fact Book, available at:
http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=655&category=3

- We strongly urge the Commission to reconsider how it would allow for block trades to occur, if the Commission were to adopt a trade-through rule. A benchmark order exception, even one that allows for negotiations at price points better than VWAP (for example, a block trade in which an investor buys at VWAP minus 2 cents per share), introduces the very uncertainty over price that a mutual fund manager seeks to avoid by entering into a block trade in the first place. It is likely to be of little solace to a fund manager who directs the trading desk at 10 a.m. to lock an all-in price to buy one million shares of a stock, to learn at the end of the trading day that the desk was able to negotiate a benchmark order trade of VWAP minus 2 cents per share, if the VWAP for that stock is up 20% over the prior day's close.

III. **The Commission's Economic Studies Regarding the Need for a Trade-Through Rule Are Flawed.**

It is critical that such fundamental changes to our equity markets like those proposed by Regulation NMS be supported with well reasoned and thoughtful research. To this end, the Commission has posted the work of its Office of Economic Analysis relating to the need for a trade-through rule, including the extension of such a rule to the market for Nasdaq securities. However, we bring to the attention of this Committee that the Commission's analysis, as set forth in the OEA's study entitled, "Analysis of Trade-throughs in Nasdaq and NYSE Issues," dated December 15, 2004, is open to serious question and likely rests on serious methodological flaws. We have reviewed the comment letter filed by Professor James J. Angel. Associate Professor of Finance, Georgetown University and believe his criticisms of the OEA's analysis have substantial merit. (Fidelity did not engage Professor Angel to conduct his review, and we were not privy to any of his work in this regard prior to the filing of his comment letter.)

Our own preliminary review of the OEA's study suggests that trade-throughs of displayed superior orders equal to or greater in size than the incoming "trading-through" order may amount to only 0.4% of Nasdaq volume, and perhaps only 0.22% of NYSE share volume – hardly sufficient to justify the intervention of the federal government to deny investors the freedom to choose the market where their trades are to be executed. The overstatement of limit orders traded through in the OEA's analysis necessarily carries over to the OEA's estimate of the total dollar "loss" occasioned by trade throughs. Our preliminary estimate, even assuming the Commission's theory of "loss" arising from trade throughs, is in the minimal range of $16 million per year.

We expect that access fees, leading to locked and crossed markets, may have been a primary cause of many of the perceived trade-throughs, that "race conditions," resulting from attempts to sweep the market, may well have been responsible for others and the activation of reserve quantities for still others. In any event, it is not necessarily the case that a limit order placed in one market center that was traded through by another market center would have been executed at its limit price had it been presented in the second market. It may well have lost out to other orders presented to that market at or about the same time. As a result, the "benefits" to investors of preventing trade throughs are by no

means clearly established. Without further, more detailed information on the actual trades themselves, we cannot be sure what the data in the Commission's trade-through study show.

In light of these serious questions regarding the OEA's findings and methodology, we urge this Committee to ask the Commission to direct OEA to conduct further evaluations of trade throughs, particularly purported trade throughs in the Nasdaq market **before it finalizes** Regulation NMS. Those further evaluations should look not only at the publicly available data filed under Securities Exchange Act Rule 11Ac1-5 but also the OATS data on trading in Nasdaq securities and the audit trail data the NYSE gathers. That further evaluation should consider whether the trade throughs the Commission believes it found during the period covered by the OEA study were in fact trade throughs or instead were false positives occasioned by locked and crossed markets, race conditions, and the impact of "reserve" and replenishment.

We appreciate this opportunity to present our views to the Committee.

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